

Question #1 of 60

Question ID: 627635

Use the following information to answer Questions 61 through 66.

Chester Brothers, LLC, is an investment management firm with \$200 million in assets under management. Chester's equity style is described to clients as a large-cap core strategy. One year ago, Chester instituted a new compensation plan for its equity portfolio managers. Under this new plan, each portfolio manager receives an annual bonus based upon that manager's quarterly performance relative to the S&P 500 index. For each quarter of out-performance, the manager receives a bonus in the amount of 20% of his regular annual compensation. Chester has not disclosed this new plan to clients. Portfolio managers at Chester are not bound by non-compete agreements.

James Rogers, CFA, and Karen Pierce, CFA, are both portfolio managers affected by the new policy. Rogers out-performed the S&P 500 index in each of the last three quarters, largely because he began investing his clients' funds in small-cap securities. Chester has recently been citing Rogers's performance in local media advertising, including claims that "Chester's star manager, James Rogers, has outperformed the S&P 500 index in each of the last three quarters." The print advertising associated with the media campaign includes a photograph of Rogers, identifying him as James Rogers, CFA. Below his name is a quote apparently attributable to Rogers saying "as a CFA charterholder, I am committed to the highest ethical standards."

A few weeks after the advertising campaign began, Rogers was approached by the Grumpp Foundation, a local charitable endowment with \$3 billion in assets, about serving on its investment advisory committee. The committee meets weekly to review the portfolio and make adjustments as needed. The Grumpp trustees were impressed by the favorable mention of Rogers in the marketing campaign. In making their offer, they even suggested that Rogers could mention his position on the advisory committee in future Chester marketing material. Rogers has not informed Chester about the Grumpp offer, but he has not yet accepted the position.

Pierce has not fared as well as Rogers. She also shifted into smaller-cap securities, but due to two extremely poor performing large-cap stocks, her performance lagged the S&P 500 index for the first three quarters. After an angry confrontation with her supervisor, Pierce resigned. When she left, Pierce took a copy of a computer model with the permission of the co-worker who developed the model, as well as the most recent list of her buy recommendations, which was created from the output of the computer model. Pierce soon accepted a position at a competing firm, Cheeri Group. On her first day at Cheeri, she contacted each of her five largest former clients, informing them of her new employment and asking that they consider moving their accounts from Chester to Cheeri. During both telephone conversations and e-mails with her former clients, Pierce mentioned that Chester had a new compensation program that created incentives for managers to shift into smaller-cap securities.

Cheeri has posted Pierce's investment performance for the past five years on its Web site, excluding the three most recent quarters. The footnotes to the performance information include the following two statements:

Statement 1: Includes large capitalization portfolios only.

Statement 2: Results reflect manager's performance at previous employer.

.....

Chester's new compensation plan for awarding bonuses to individual portfolio managers:

- A) is consistent with CFA Institute Standards and does not require disclosure.
 - B) is consistent with CFA Institute Standards only if fully disclosed to clients.
 - C) is consistent with CFA Institute Standards, but any bonuses awarded under the plan must be fully disclosed to clients.
-

Question #2 of 60

Question ID: 627636

Chester Brothers, LLC, is an investment management firm with \$200 million in assets under management. Chester's equity style is described to clients as a large-cap core strategy. One year ago, Chester instituted a new compensation plan for its equity portfolio managers. Under this new plan, each portfolio manager receives an annual bonus based upon that manager's quarterly performance relative to the S&P 500 index. For each quarter of out-performance, the manager receives a bonus in the amount of 20% of his regular annual compensation. Chester has not disclosed this new plan to clients. Portfolio managers at Chester are not bound by non-compete agreements.

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Cheeri has posted Pierce's investment performance for the past five years on its Web site, excluding the three most recent quarters. The footnotes to the performance information include the following two statements:

- Statement 1: Includes large capitalization portfolios only.
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Assuming Rogers would like to accept the offer to serve on the Grumpp investment advisory committee, Rogers's obligations under the CFA Institute Standards require that he:

- A) refuse to serve on the Grumpp committee.
- B) accept the Grumpp committee position only after disclosing the offer to his supervisor.
- C) accept the Grumpp committee position and disclose his acceptance as soon as possible to his supervisor.

Question #3 of 60

Question ID: 627637

Chester Brothers, LLC, is an investment management firm with \$200 million in assets under management. Chester's equity style is described to clients as a large-cap core strategy. One year ago, Chester instituted a new compensation plan for its equity portfolio managers. Under this new plan, each portfolio manager receives an annual bonus based upon that manager's quarterly performance relative to the S&P 500 index. For each quarter of out-performance, the manager receives a bonus in the amount of 20% of his regular annual compensation. Chester has not disclosed this new plan to clients. Portfolio managers at Chester are not bound by non-compete agreements.

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Cheeri has posted Pierce's investment performance for the past five years on its Web site, excluding the three most recent quarters. The footnotes to the performance information include the following two statements:

Statement 1: Includes large capitalization portfolios only.

Statement 2: Results reflect manager's performance at previous employer.

Chester's advertising campaign includes claims about Rogers's investment performance, as well as Rogers's use and reference to the CFA charter. Is Chester's advertising campaign consistent with the CFA Institute Standards?

- A) Chester's performance claims are inconsistent with CFA Institute Standards, but his use and reference to the CFA designation is appropriate.
 - B) Both the performance claim and the reference to the CFA charter are violations.
 - C) Neither the performance claims nor the use and reference to the CFA designation are violations.
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Question #4 of 60

Question ID: 627638

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Statement 2: Results reflect manager's performance at previous employer.

Under the CFA Institute Standards, Pierce taking the computer model when leaving her position at Chester would be *best* described as a violation:

- A) because she should have obtained written permission from her co-worker.
- B) unless she obtained permission from both her co-worker as well as from Chester.
- C) unless she obtained permission from Chester Brothers, LLC.

Question #5 of 60

Question ID: 627639

Chester Brothers, LLC, is an investment management firm with \$200 million in assets under management. Chester's equity style is described to clients as a large-cap core strategy. One year ago, Chester instituted a new compensation plan for its equity portfolio managers. Under this new plan, each portfolio manager receives an annual bonus based upon that manager's quarterly performance relative to the S&P 500 index. For each quarter of out-performance, the manager receives a bonus in the amount of 20% of his regular annual compensation. Chester has not disclosed this new plan to clients. Portfolio managers at Chester are not bound by non-compete agreements.

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Cheeri has posted Pierce's investment performance for the past five years on its Web site, excluding the three most recent quarters. The footnotes to the performance information include the following two statements:

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Statement 2: Results reflect manager's performance at previous employer.

Pierce's behavior upon assuming her new position at Cheeri can *best* be described as violating CFA Institute Standards because she:

- A) encouraged her former clients to leave Chester.
- B) should not have contacted her former clients at all.
- C) disclosed Chester's new compensation program.

Question #6 of 60

Question ID: 627640

Chester Brothers, LLC, is an investment management firm with \$200 million in assets under management. Chester's equity style is described to clients as a large-cap core strategy. One year ago, Chester instituted a new compensation plan for its equity portfolio managers. Under this new plan, each portfolio manager receives an annual bonus based upon that manager's quarterly performance relative to the S&P 500 index. For each quarter of out-performance, the manager receives a bonus in the amount of 20% of his regular annual compensation. Chester has not disclosed this new plan to clients. Portfolio managers at Chester are not bound by non-compete agreements.

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Cheeri has posted Pierce's investment performance for the past five years on its Web site, excluding the three most recent quarters. The footnotes to the performance information include the following two statements:

Statement 1: Includes large capitalization portfolios only.

Statement 2: Results reflect manager's performance at previous employer.

Cheeri's presentation of Pierce's investment performance is inconsistent with CFA Institute Standards because:

- A) the results were not calculated under GIPS.
- B) performance from a previous employer should not be included.
- C) the results misrepresent Pierce's large cap performance.

Question #7 of 60

Question ID: 691717

Use the following information to answer Questions 67 through 72.

Austin Clark, CFA, has been asked to analyze White Goods Corporation, a \$9 billion company that owns a nationwide chain of stores selling appliances and other electronic goods. As part of his analysis of the White Goods Corporation, Clark's supervisor, David Horvath, asks Clark to forecast White Goods' 2009 sales using multiple regression analysis. The following model was developed:

sales =	20.1	+	0.001	GDP	+	1,000.6	TR	+	0.1	CC	−	3.2	PC	−	40.3	UR
t-values:	(1.1)		(2.3)		(1.75)		(3.2)		(−0.48)		(−0.9)					
Number of observations:	76															
Standard error estimate:	15.67															
Unadjusted R ² :	0.96															
Regression sum of squares:	412,522															
Error sum of squares:	17,188															

Independent Variable Descriptions

GDP = gross domestic product

TR = average rate on 5-year U.S. Treasury securities

CC = most recent quarter end consumer confidence index value

PC = previous year's sales of personal computers

UR = most recent quarter end unemployment rate

Variable Estimates for 2009

GDP = 8,000

TR = 0.05

CC = 97

PC = 60,000

UR = 0.055

Critical Values For Student's t-Distribution

Degrees of Freedom	Level of Significance for One-Tailed Test			
	10%	5%	2.5%	1%
	Level of Significance for Two-Tailed Test			
	20%	10%	5%	2%
5	1.476	2.015	2.571	3.365
15	1.341	1.753	2.131	2.602
25	1.316	1.708	2.060	2.485
50	1.299	1.676	2.009	2.403
60	1.296	1.671	2.000	2.390
70	1.294	1.667	1.994	2.381

Clark's supervisor asks him to prepare a report explaining the implications of the regression analysis results. Clark writes the following conclusions concerning regression analysis in his report:

Interpreting the results of regression analysis can be problematic if certain assumptions of the ordinary least squares framework are violated. The regression output for White Goods Corporation is unreliable for the following reasons:

Finding 1: The correlation between regression errors across time is very close to 1.

Finding 2: There is a strong relationship between the regression error variance and the regression independent variables.

Using his multiple linear regression, Clark's sales forecast for 2009 is *closest* to:

- A) -\$191,914.
- B) \$18.
- C) \$192,090.

Austin Clark, CFA, has been asked to analyze White Goods Corporation, a \$9 billion company that owns a nationwide chain of stores selling appliances and other electronic goods. As part of his analysis of the White Goods Corporation, Clark's supervisor, David Horvath, asks Clark to forecast White Goods' 2009 sales using multiple regression analysis. The following model was developed:

$\text{sales} = 20.1 + 0.001 \text{ GDP} + 1,000.6 \text{ TR} + 0.1 \text{ CC} - 3.2 \text{ PC} - 40.3 \text{ UR}$
 $t\text{-values: (1.1) \quad (2.3) \quad (1.75) \quad (3.2) \quad (-0.48) \quad (-0.9)}$
 Number of observations: 76
 Standard error estimate: 15.67
 Unadjusted R^2 : 0.96
 Regression sum of squares: 412,522
 Error sum of squares: 17,188

Independent Variable Descriptions

GDP = gross domestic product
 TR = average rate on 5-year U.S. Treasury securities
 CC = most recent quarter end consumer confidence index value
 PC = previous year's sales of personal computers
 UR = most recent quarter end unemployment rate

Variable Estimates for 2009

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Critical Values For Student's t -Distribution

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Interpreting the results of regression analysis can be problematic if certain assumptions of the ordinary least squares framework are violated. The regression output for White Goods Corporation is unreliable for the following reasons:

Finding 1: The correlation between regression errors across time is very close to 1.

Finding 2: There is a strong relationship between the regression error variance and the regression independent variables.

Is the regression coefficient of the 5-year U.S. Treasury interest rate statistically significantly different from zero at the 10% level of significance?

- A) Yes, because $1.75 > 1.29$.
- B) Yes, because $1.75 > 1.67$.
- C) No, because $1.75 < 1.99$.

Question #9 of 60

Question ID: 691715

Austin Clark, CFA, has been asked to analyze White Goods Corporation, a \$9 billion company that owns a nationwide chain of stores selling appliances and other electronic goods. As part of his analysis of the White Goods Corporation, Clark's supervisor, David Horvath, asks Clark to forecast White Goods' 2009 sales using multiple regression analysis. The following model was developed:

sales = $20.1 + 0.001 \text{ GDP} + 1,000.6 \text{ TR} + 0.1 \text{ CC} - 3.2 \text{ PC} - 40.3 \text{ UR}$

t-values: (1.1) (2.3) (1.75) (3.2) (-0.48) (-0.9)

Number of observations: 76

Standard error estimate: 15.67

Unadjusted R^2 : 0.96

Regression sum of squares: 412,522

Error sum of squares: 17,188

Independent Variable Descriptions

GDP = gross domestic product

TR = average rate on 5-year U.S. Treasury securities

CC = most recent quarter end consumer confidence index value

PC = previous year's sales of personal computers

UR = most recent quarter end unemployment rate

Variable Estimates for 2009

GDP = 8,000

TR = 0.05

CC = 97

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Critical Values For Student's *t*-Distribution

Degrees of Freedom	Level of Significance for One-Tailed Test			
	10%	5%	2.5%	1%
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Clark's supervisor asks him to prepare a report explaining the implications of the regression analysis results. Clark writes the following conclusions concerning regression analysis in his report:

Interpreting the results of regression analysis can be problematic if certain assumptions of the ordinary least squares framework are violated. The regression output for White Goods Corporation is unreliable for the following reasons:

Finding 1: The correlation between regression errors across time is very close to 1.

Finding 2: There is a strong relationship between the regression error variance and the regression independent variables.

In this multiple regression equation, a potential statistical issue is:

- A) the coefficient of determination indicates a weak model.
- B) that sales cannot be statistically modeled.
- C) the PC variable is not a statistically significant variable.

Question #10 of 60

Question ID: 691718

Austin Clark, CFA, has been asked to analyze White Goods Corporation, a \$9 billion company that owns a nationwide chain of stores selling appliances and other electronic goods. As part of his analysis of the White Goods Corporation, Clark's supervisor, David Horvath, asks Clark to forecast White Goods' 2009 sales using multiple regression analysis. The following model was developed:

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t-values: (1.1) (2.3) (1.75) (3.2) (−0.48) (−0.9)

Number of observations:	76
Standard error estimate:	15.67
Unadjusted R ² :	0.96
Regression sum of squares:	412,522
Error sum of squares:	17,188

Independent Variable Descriptions

GDP = gross domestic product

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CC = most recent quarter end consumer confidence index value

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Variable Estimates for 2009

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Finding 1: The correlation between regression errors across time is very close to 1.

Finding 2: There is a strong relationship between the regression error variance and the regression independent variables.

What is the F -value that tests the hypothesis that all of the coefficients are equal to zero?

- A) 42.0.
- B) 101.0.
- C) 336.0.

Question #11 of 60

Question ID: 691719

Austin Clark, CFA, has been asked to analyze White Goods Corporation, a \$9 billion company that owns a nationwide chain of stores selling appliances and other electronic goods. As part of his analysis of the White Goods Corporation, Clark's supervisor, David Horvath, asks Clark to forecast White Goods' 2009 sales using multiple regression analysis. The following model was developed:

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Finding 1: The correlation between regression errors across time is very close to 1.

Finding 2: There is a strong relationship between the regression error variance and the regression independent variables.

In his report to his supervisor, Clark's test of serial correlation indicates that the t -statistics for the regression estimates likely are:

- A) biased upward.
- B) biased downward.
- C) unbiased.

Question #12 of 60

Question ID: 691720

Austin Clark, CFA, has been asked to analyze White Goods Corporation, a \$9 billion company that owns a nationwide chain of stores selling appliances and other electronic goods. As part of his analysis of the White Goods Corporation, Clark's supervisor, David Horvath, asks Clark to forecast White Goods' 2009 sales using multiple regression analysis. The following model was developed:

$$\text{sales} = 20.1 + 0.001 \text{ GDP} + 1,000.6 \text{ TR} + 0.1 \text{ CC} - 3.2 \text{ PC} - 40.3 \text{ UR}$$

t -values: (1.1) (2.3) (1.75) (3.2) (-0.48) (-0.9)

Number of observations: 76

Standard error estimate: 15.67

Unadjusted R^2 : 0.96

Regression sum of squares: 412,522

Error sum of squares: 17,188

Independent Variable Descriptions

GDP = gross domestic product

TR = average rate on 5-year U.S. Treasury securities

CC = most recent quarter end consumer confidence index value

PC = previous year's sales of personal computers

UR = most recent quarter end unemployment rate

Variable Estimates for 2009

GDP = 8,000

TR = 0.05

CC = 97

PC = 60,000

UR = 0.055

Critical Values For Student's *t*-Distribution

Degrees of Freedom	Level of Significance for One-Tailed Test			
	10%	5%	2.5%	1%
	Level of Significance for Two-Tailed Test			
	20%	10%	5%	2%
5	1.476	2.015	2.571	3.365
15	1.341	1.753	2.131	2.602
25	1.316	1.708	2.060	2.485
50	1.299	1.676	2.009	2.403
60	1.296	1.671	2.000	2.390
70	1.294	1.667	1.994	2.381

Clark's supervisor asks him to prepare a report explaining the implications of the regression analysis results. Clark writes the following conclusions concerning regression analysis in his report:

Interpreting the results of regression analysis can be problematic if certain assumptions of the ordinary least squares framework are violated. The regression output for White Goods Corporation is unreliable for the following reasons:

Finding 1: The correlation between regression errors across time is very close to 1.

Finding 2: There is a strong relationship between the regression error variance and the regression independent variables.

Clark's two documented findings related to his examination of the regression errors should lead to the conclusion that Clark's regression equation exhibits strong evidence of:

A) conditional heteroskedasticity.

B) multicollinearity.

C) unit roots.

Question #13 of 60

Question ID: 691721

Use the following information to answer Questions 73 through 78.

Curtis Fox, an equity analyst for Altex Investments, is reviewing financial statements for Hope Manufacturing and Levitt Industries. Hope Manufacturing has recently stated its intention to acquire a 20% stake in Levitt Industries for \$185 million cash. Both companies are U.S. companies that follow U.S. GAAP.

Fox wants to consolidate his pro-forma financial statements for the two companies to see the effects of the proposed acquisition. Following are the most recent balance sheets and the pro-forma income statements developed by Fox before taking into account the acquisition.

Pre-Acquisition Balance Sheets (in million \$)	Hope	Levitt
December 31, 2010		
Current assets	13,900	716
PP&E	26,977	108
Total assets	40,877	824

Current liabilities	10,363	220
Other liabilities	11,121	8
Common stock	6,127	108
Retained earnings	13,266	488
Total liabilities and equity	40,877	824

Pro-Forma Income Statements (in million \$)	Hope	Levitt
for Year Ending December 31, 2011		
Revenue	66,176	2,176
Expenses	63,515	2,068
Net income	2,661	108
Dividends	1,525	0

Fox is concerned about the effect that the choice of accounting method will have on the earnings and financial ratios of Hope. Fox consults with Jeffery Gordon, who tells him, "Since Levitt is profitable and pays no dividends, the equity method will result in higher net income than the acquisition method. Additionally, the equity method will result in lower return on assets (ROA) than the acquisition method with partial goodwill."

Assuming the acquisition goes through at the beginning of 2011, and that Hope will have a significant influence on Levitt, Hope's total assets after acquisition would be *closest* to:

A) \$40,877.

B) \$41,062.

C) \$41,701.

Question #14 of 60

Question ID: 693182

Curtis Fox, an equity analyst for Altex Investments, is reviewing financial statements for Hope Manufacturing and Levitt Industries. Hope Manufacturing has recently stated its intention to acquire a 20% stake in Levitt Industries for \$185 million cash. Both companies are U.S. companies that follow U.S. GAAP.

Fox wants to consolidate his pro-forma financial statements for the two companies to see the effects of the proposed acquisition. Following are the most recent balance sheets and the pro-forma income statements developed by Fox before taking into account the acquisition.

Pre-Acquisition Balance Sheets (in million \$)	Hope	Levitt
December 31, 2010		
Current assets	13,900	716
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Total assets	40,877	824
Current liabilities	10,363	220
Other liabilities	11,121	8
Common stock	6,127	108
Retained earnings	13,266	488
Total liabilities and equity	40,877	824

Pro-Forma Income Statements (in million \$)	Hope	Levitt
for Year Ending December 31, 2011		
Revenue	66,176	2,176
Expenses	63,515	2,068
Net income	2,661	108
Dividends	1,525	0

Fox is concerned about the effect that the choice of accounting method will have on the earnings and financial ratios of Hope. Fox consults with Jeffery Gordon, who tells him, "Since Levitt is profitable and pays no dividends, the equity method will result in higher net income than the acquisition method. Additionally, the equity method will result in lower return on assets (ROA) than the acquisition method with partial goodwill."

Fox estimates that the fair value of Levitt's PP&E is \$250 million. The amount allocated to goodwill would be *closest* to:

- A) \$20.2 million.
- B) \$37.4 million.
- C) \$65.8 million.

Question #15 of 60

Question ID: 693183

Curtis Fox, an equity analyst for Altex Investments, is reviewing financial statements for Hope Manufacturing and Levitt Industries. Hope Manufacturing has recently stated its intention to acquire a 20% stake in Levitt Industries for \$185 million cash. Both companies are U.S. companies that follow U.S. GAAP.

Fox wants to consolidate his pro-forma financial statements for the two companies to see the effects of the proposed acquisition. Following are the most recent balance sheets and the pro-forma income statements developed by Fox before taking into account the acquisition.

Pre-Acquisition Balance Sheets (in million \$)		
	Hope	Levitt
December 31, 2010		
Current assets	13,900	716
PP&E	26,977	108
Total assets	40,877	824
Current liabilities	10,363	220
Other liabilities	11,121	8
Common stock	6,127	108
Retained earnings	13,266	488
Total liabilities and equity	40,877	824
Pro-Forma Income Statements (in million \$)		
	Hope	Levitt
for Year Ending December 31, 2011		
Revenue	66,176	2,176
Expenses	63,515	2,068
Net income	2,661	108
Dividends	1,525	0

Fox is concerned about the effect that the choice of accounting method will have on the earnings and financial ratios of Hope. Fox consults with Jeffery Gordon, who tells him, "Since Levitt is profitable and pays no dividends, the equity method will result in higher net income than the acquisition method. Additionally, the equity method will result in lower return on assets (ROA) than the acquisition method with partial goodwill."

For this question only, assume that as a result of the acquisition, Hope must depreciate an additional \$50 million over a 10-year period to zero salvage value. Levitt's contribution to Hope's EBT for 2011 is projected to be *closest* to:

- A) \$16.6 million.
- B) \$18.8 million.
- C) \$21.6 million.

Question #16 of 60

Question ID: 691724

Curtis Fox, an equity analyst for Altex Investments, is reviewing financial statements for Hope Manufacturing and Levitt Industries. Hope Manufacturing has recently stated its intention to acquire a 20% stake in Levitt Industries for \$185 million cash. Both companies are U.S. companies that follow U.S. GAAP.

Fox wants to consolidate his pro-forma financial statements for the two companies to see the effects of the proposed acquisition. Following are the most recent balance sheets and the pro-forma income statements developed by Fox before taking into account the acquisition.

Pre-Acquisition Balance Sheets (in million \$)		
	Hope	Levitt
December 31, 2010		
Current assets	13,900	716
PP&E	26,977	108
Total assets	40,877	824
Current liabilities	10,363	220
Other liabilities	11,121	8
Common stock	6,127	108
Retained earnings	13,266	488
Total liabilities and equity	40,877	824
Pro-Forma Income Statements (in million \$)		
	Hope	Levitt
for Year Ending December 31, 2011		
Revenue	66,176	2,176
Expenses	63,515	2,068
Net income	2,661	108
Dividends	1,525	0

Fox is concerned about the effect that the choice of accounting method will have on the earnings and financial ratios of Hope. Fox consults with Jeffery Gordon, who tells him, "Since Levitt is profitable and pays no dividends, the equity method will result in higher net income than the acquisition method. Additionally, the equity method will result in lower return on assets (ROA) than the acquisition method with partial goodwill."

For this question only, assume the acquisition occurs on December 31, 2010, and that there is no additional depreciation expense as a result of the acquisition. Compared to its beginning of year investment balance, the balance for Hope's investment in Levitt on December 31, 2011, will be:

- A) lower.
- B) higher.
- C) unchanged.

Question #17 of 60

Question ID: 691726

Curtis Fox, an equity analyst for Altex Investments, is reviewing financial statements for Hope Manufacturing and Levitt Industries. Hope Manufacturing has recently stated its intention to acquire a 20% stake in Levitt Industries for \$185 million cash. Both companies are U.S. companies that follow U.S. GAAP.

Fox wants to consolidate his pro-forma financial statements for the two companies to see the effects of the proposed acquisition. Following are the most recent balance sheets and the pro-forma income statements developed by Fox before taking into account the acquisition.

Pre-Acquisition Balance Sheets (in million \$)		
	Hope	Levitt
December 31, 2010		
Current assets	13,900	716
PP&E	26,977	108
Total assets	40,877	824
Current liabilities	10,363	220
Other liabilities	11,121	8
Common stock	6,127	108
Retained earnings	13,266	488
Total liabilities and equity	40,877	824
Pro-Forma Income Statements (in million \$)		
	Hope	Levitt
for Year Ending December 31, 2011		
Revenue	66,176	2,176
Expenses	63,515	2,068
Net income	2,661	108
Dividends	1,525	0

Fox is concerned about the effect that the choice of accounting method will have on the earnings and financial ratios of Hope. Fox consults with Jeffery Gordon, who tells him, "Since Levitt is profitable and pays no dividends, the equity method will result in higher net income than the acquisition method. Additionally, the equity method will result in lower return on assets (ROA) than the acquisition method with partial goodwill."

Is Gordon's statement regarding the effects of the choice of accounting method on net income and ROA correct?

- A) Yes.
- B) No, he is incorrect regarding the effect on ROA.
- C) No, he is incorrect regarding the effect on net income and ROA.

Question #18 of 60

Question ID: 691725

Curtis Fox, an equity analyst for Altex Investments, is reviewing financial statements for Hope Manufacturing and Levitt Industries. Hope Manufacturing has recently stated its intention to acquire a 20% stake in Levitt Industries for \$185 million cash. Both companies are U.S. companies that follow U.S. GAAP.

Fox wants to consolidate his pro-forma financial statements for the two companies to see the effects of the proposed acquisition. Following are the most recent balance sheets and the pro-forma income statements developed by Fox before taking into account the acquisition.

Pre-Acquisition Balance Sheets (in million \$)		
	Hope	Levitt
December 31, 2010		
Current assets	13,900	716
PP&E	26,977	108
Total assets	40,877	824
Current liabilities	10,363	220
Other liabilities	11,121	8
Common stock	6,127	108
Retained earnings	13,266	488
Total liabilities and equity	40,877	824

Pro-Forma Income Statements (in million \$)		
	Hope	Levitt
for Year Ending December 31, 2011		
Revenue	66,176	2,176
Expenses	63,515	2,068
Net income	2,661	108
Dividends	1,525	0

Fox is concerned about the effect that the choice of accounting method will have on the earnings and financial ratios of Hope. Fox consults with Jeffery Gordon, who tells him, "Since Levitt is profitable and pays no dividends, the equity method will result in higher net income than the acquisition method. Additionally, the equity method will result in lower return on assets (ROA) than the acquisition method with partial goodwill."

If Fox were to follow IFRS instead of U.S. GAAP, the accounting method prescribed for this type of investment would *most likely* be:

- A) the equity method.
- B) the acquisition method.
- C) proportionate consolidation.

Question #19 of 60

Question ID: 691732

Use the following information to answer Questions 79 through 84.

Fashion, Inc., is a major U.S. distributor of high-quality women's jewelry and accessories. The company's growth in recent years has been moderately above the industry average. However, competition is intensifying as a number of overseas competitors have entered this mature market. Although Fashion has been a publicly held company for many years, members of senior management and their families control 20% of the outstanding common stock. Martin Silver, the chief executive officer, has been under intense pressure from both internal and external large shareholders to find ways to increase the company's future growth.

Silver has consulted with the company's investment bankers concerning possible merger targets. The most promising merger target is Flavoring International, a distributor of a broad line of gourmet spices in the United States and numerous other countries. In recent years, Flavoring's earnings growth rate has been above competitors' and also has exceeded Fashion's experience. Superior income growth is projected to continue over at least the next five years. Silver is impressed with the appeal of the company's products to upscale customers, its strong operating and financial performance, and Flavoring's dynamic management team. He is contemplating retirement in three years and believes that Flavoring's younger, more aggressive senior managers could boost the combined company's growth through increasing Fashion's operating efficiency and expanding Fashion's product line in countries outside the United States. Alan Smith, who is Silver's key contact at the investment banking firm, indicates that a key appeal of this merger to Flavoring would be Fashion's greater financial flexibility and access to lower cost sources of financing for expansion of its products in new geographic areas. Fashion has a very attractive performance based stock option plan. Flavoring's incentive plan is entirely based on cash compensation for achieving performance goals. Additionally, the 80% of Fashion's stock not controlled by management interests is very widely held and trades actively. Flavoring became a publicly held company three years ago and doesn't trade as actively.

Silver has asked Smith to prepare a report summarizing key points favoring the acquisition and an acceptable acquisition price. In preparing his report, Smith relies on the following financial data on Fashion, Flavoring, and four recently acquired food and beverage companies.

Exhibit 1: Financial and Market Data for Fashion, Inc. and Flavoring International

<i>Financial/Price Data</i>	<i>Fashion</i>	<i>Flavoring</i>
Sales	\$400 million	\$105 million
Net income	\$80 million	\$22 million
Cash flow	\$140 million	\$42 million
Book value	\$320 million	\$72 million
Number of common shares outstanding	50 million	20 million
Current market price of common stock	\$30.50	\$20.00
Recent market price range	\$34-26	\$22-18

Exhibit 2: Transaction Data for Food and Beverage Industry

<i>Valuation Variables</i>	<i>Jones Foods</i>	<i>Dale, Inc.</i>	<i>Hill Brands</i>	<i>Lane Co.</i>	<i>Mean Multiple</i>
Acquisition stock price	\$24	\$32	\$40	\$46	-
Price/sales per share	5.0	3.7	4.0	3.8	4.13

Price/book value per share	6.9	5.5	5.8	5.6	5.95
Price/earnings per share	20.0	22.1	18.0	19.0	19.78
Price/cash flow per share	11.8	13.0	10.5	11.0	11.58

The strongest motivations for Fashion to acquire Flavoring would *most likely* be:

- A) the potential to increase Fashion's growth and market power.
- B) the potential to create synergies and increase market power.
- C) Fashion management's incentives and diversification.

Question #20 of 60

Question ID: 691733

Fashion, Inc., is a major U.S. distributor of high-quality women's jewelry and accessories. The company's growth in recent years has been moderately above the industry average. However, competition is intensifying as a number of overseas competitors have entered this mature market. Although Fashion has been a publicly held company for many years, members of senior management and their families control 20% of the outstanding common stock. Martin Silver, the chief executive officer, has been under intense pressure from both internal and external large shareholders to find ways to increase the company's future growth.

Silver has consulted with the company's investment bankers concerning possible merger targets. The most promising merger target is Flavoring International, a distributor of a broad line of gourmet spices in the United States and numerous other countries. In recent years, Flavoring's earnings growth rate has been above competitors' and also has exceeded Fashion's experience. Superior income growth is projected to continue over at least the next five years. Silver is impressed with the appeal of the company's products to upscale customers, its strong operating and financial performance, and Flavoring's dynamic management team. He is contemplating retirement in three years and believes that Flavoring's younger, more aggressive senior managers could boost the combined company's growth through increasing Fashion's operating efficiency and expanding Fashion's product line in countries outside the United States. Alan Smith, who is Silver's key contact at the investment banking firm, indicates that a key appeal of this merger to Flavoring would be Fashion's greater financial flexibility and access to lower cost sources of financing for expansion of its products in new geographic areas. Fashion has a very attractive performance based stock option plan. Flavoring's incentive plan is entirely based on cash compensation for achieving performance goals. Additionally, the 80% of Fashion's stock not controlled by management interests is very widely held and trades actively. Flavoring became a publicly held company three years ago and doesn't trade as actively.

Silver has asked Smith to prepare a report summarizing key points favoring the acquisition and an acceptable acquisition price. In preparing his report, Smith relies on the following financial data on Fashion, Flavoring, and four recently acquired food and beverage companies.

Exhibit 1: Financial and Market Data for Fashion, Inc. and Flavoring International

Financial/Price Data

Fashion

Flavoring

Sales	\$400 million	\$105 million
Net income	\$80 million	\$22 million
Cash flow	\$140 million	\$42 million
Book value	\$320 million	\$72 million
Number of common shares outstanding	50 million	20 million
Current market price of common stock	\$30.50	\$20.00
Recent market price range	\$34-26	\$22-18

Exhibit 2: Transaction Data for Food and Beverage Industry

Valuation Variables	Jones Foods	Dale, Inc.	Hill Brands	Lane Co.	Mean Multiple
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Price/book value per share	6.9	5.5	5.8	5.6	5.95
Price/earnings per share	20.0	22.1	18.0	19.0	19.78
Price/cash flow per share	11.8	13.0	10.5	11.0	11.58

The *least likely* reason that Flavoring's management would favor an acquisition by Fashion would be:

- A) Flavoring management's incentives.
- B) opportunities to utilize Fashion's larger financial resources to increase market share of both companies.
- C) opportunities to utilize Fashion's financial resources to expand the combined company's product line into the higher volume moderately priced market segment.

Question #21 of 60

Question ID: 691734

Fashion, Inc., is a major U.S. distributor of high-quality women's jewelry and accessories. The company's growth in recent years has been moderately above the industry average. However, competition is intensifying as a number of overseas competitors have entered this mature market. Although Fashion has been a publicly held company for many years, members of senior management and their families control 20% of the outstanding common stock. Martin Silver, the chief executive officer, has been under intense pressure from both internal and external large shareholders to find ways to increase the company's future growth.

Silver has consulted with the company's investment bankers concerning possible merger targets. The most promising merger target is Flavoring International, a distributor of a broad line of gourmet spices in the United States and numerous other

countries. In recent years, Flavoring's earnings growth rate has been above competitors' and also has exceeded Fashion's experience. Superior income growth is projected to continue over at least the next five years. Silver is impressed with the appeal of the company's products to upscale customers, its strong operating and financial performance, and Flavoring's dynamic management team. He is contemplating retirement in three years and believes that Flavoring's younger, more aggressive senior managers could boost the combined company's growth through increasing Fashion's operating efficiency and expanding Fashion's product line in countries outside the United States. Alan Smith, who is Silver's key contact at the investment banking firm, indicates that a key appeal of this merger to Flavoring would be Fashion's greater financial flexibility and access to lower cost sources of financing for expansion of its products in new geographic areas. Fashion has a very attractive performance based stock option plan. Flavoring's incentive plan is entirely based on cash compensation for achieving performance goals. Additionally, the 80% of Fashion's stock not controlled by management interests is very widely held and trades actively. Flavoring became a publicly held company three years ago and doesn't trade as actively.

Silver has asked Smith to prepare a report summarizing key points favoring the acquisition and an acceptable acquisition price. In preparing his report, Smith relies on the following financial data on Fashion, Flavoring, and four recently acquired food and beverage companies.

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Exhibit 2: Transaction Data for Food and Beverage Industry

<i>Valuation Variables</i>	<i>Jones Foods</i>	<i>Dale, Inc.</i>	<i>Hill Brands</i>	<i>Lane Co.</i>	<i>Mean Multiple</i>
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Price/book value per share	6.9	5.5	5.8	5.6	5.95
Price/earnings per share	20.0	22.1	18.0	19.0	19.78
Price/cash flow per share	11.8	13.0	10.5	11.0	11.58

If Fashion issues common stock at the current market price and uses the proceeds to acquire Flavoring's outstanding common stock, the bootstrap earnings effect on post merger earnings would *most likely* occur if Flavoring's acquisition price:

A) is \$20 or lower.

B) is \$20 or higher.

B) is \$20 or higher.

C) is \$20 or lower and Fashion's post merger P/E remains at the current level.

Question #22 of 60

Question ID: 693185

Fashion, Inc., is a major U.S. distributor of high-quality women's jewelry and accessories. The company's growth in recent years has been moderately above the industry average. However, competition is intensifying as a number of overseas competitors have entered this mature market. Although Fashion has been a publicly held company for many years, members of senior management and their families control 20% of the outstanding common stock. Martin Silver, the chief executive officer, has been under intense pressure from both internal and external large shareholders to find ways to increase the company's future growth.

Silver has consulted with the company's investment bankers concerning possible merger targets. The most promising merger target is Flavoring International, a distributor of a broad line of gourmet spices in the United States and numerous other countries. In recent years, Flavoring's earnings growth rate has been above competitors' and also has exceeded Fashion's experience. Superior income growth is projected to continue over at least the next five years. Silver is impressed with the appeal of the company's products to upscale customers, its strong operating and financial performance, and Flavoring's dynamic management team. He is contemplating retirement in three years and believes that Flavoring's younger, more aggressive senior managers could boost the combined company's growth through increasing Fashion's operating efficiency and expanding Fashion's product line in countries outside the United States. Alan Smith, who is Silver's key contact at the investment banking firm, indicates that a key appeal of this merger to Flavoring would be Fashion's greater financial flexibility and access to lower cost sources of financing for expansion of its products in new geographic areas. Fashion has a very attractive performance based stock option plan. Flavoring's incentive plan is entirely based on cash compensation for achieving performance goals. Additionally, the 80% of Fashion's stock not controlled by management interests is very widely held and trades actively. Flavoring became a publicly held company three years ago and doesn't trade as actively.

Silver has asked Smith to prepare a report summarizing key points favoring the acquisition and an acceptable acquisition price. In preparing his report, Smith relies on the following financial data on Fashion, Flavoring, and four recently acquired food and beverage companies.

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Cash flow	\$140 million	\$42 million
Book value	\$320 million	\$72 million
Number of common shares outstanding	50 million	20 million
Current market price of common stock	\$30.50	\$20.00
Recent market price range	\$34-26	\$22-18

Exhibit 2: Transaction Data for Food and Beverage Industry

<i>Valuation Variables</i>	<i>Jones Foods</i>	<i>Dale, Inc.</i>	<i>Hill Brands</i>	<i>Lane Co.</i>	<i>Mean Multiple</i>
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Acquisition stock price	\$24	\$32	\$40	\$46	-
Price/sales per share	5.0	3.7	4.0	3.8	4.13
Price/book value per share	6.9	5.5	5.8	5.6	5.95
Price/earnings per share	20.0	22.1	18.0	19.0	19.78
Price/cash flow per share	11.8	13.0	10.5	11.0	11.58

Using the comparable transaction approach based on the four recently acquired companies, Smith determines an estimated takeover value based on equally weighted key valuation variables. The estimated takeover value would be *closest* to:

- A) \$20.27.
- B) \$21.76.
- C) \$22.30.

Question #23 of 60

Question ID: 693186

Fashion, Inc., is a major U.S. distributor of high-quality women's jewelry and accessories. The company's growth in recent years has been moderately above the industry average. However, competition is intensifying as a number of overseas competitors have entered this mature market. Although Fashion has been a publicly held company for many years, members of senior management and their families control 20% of the outstanding common stock. Martin Silver, the chief executive officer, has been under intense pressure from both internal and external large shareholders to find ways to increase the company's future growth.

Silver has consulted with the company's investment bankers concerning possible merger targets. The most promising merger target is Flavoring International, a distributor of a broad line of gourmet spices in the United States and numerous other countries. In recent years, Flavoring's earnings growth rate has been above competitors' and also has exceeded Fashion's experience. Superior income growth is projected to continue over at least the next five years. Silver is impressed with the appeal of the company's products to upscale customers, its strong operating and financial performance, and Flavoring's dynamic management team. He is contemplating retirement in three years and believes that Flavoring's younger, more aggressive senior managers could boost the combined company's growth through increasing Fashion's operating efficiency and expanding Fashion's product line in countries outside the United States. Alan Smith, who is Silver's key contact at the investment banking firm, indicates that a key appeal of this merger to Flavoring would be Fashion's greater financial flexibility and access to lower cost sources of financing for expansion of its products in new geographic areas. Fashion has a very attractive performance based stock option plan. Flavoring's incentive plan is entirely based on cash compensation for achieving performance goals. Additionally, the 80% of Fashion's stock not controlled by management interests is very widely held and trades actively. Flavoring became a publicly held company three years ago and doesn't trade as actively.

Silver has asked Smith to prepare a report summarizing key points favoring the acquisition and an acceptable acquisition

price. In preparing his report, Smith relies on the following financial data on Fashion, Flavoring, and four recently acquired food and beverage companies.

Exhibit 1: Financial and Market Data for Fashion, Inc. and Flavoring International

<i>Financial/Price Data</i>	<i>Fashion</i>	<i>Flavoring</i>
Sales	\$400 million	\$105 million
Net income	\$80 million	\$22 million
Cash flow	\$140 million	\$42 million
Book value	\$320 million	\$72 million
Number of common shares outstanding	50 million	20 million
Current market price of common stock	\$30.50	\$20.00
Recent market price range	\$34-26	\$22-18

Exhibit 2: Transaction Data for Food and Beverage Industry

<i>Valuation Variables</i>	<i>Jones Foods</i>	<i>Dale, Inc.</i>	<i>Hill Brands</i>	<i>Lane Co.</i>	<i>Mean Multiple</i>
Acquisition stock price	\$24	\$32	\$40	\$46	-
Price/sales per share	5.0	3.7	4.0	3.8	4.13
Price/book value per share	6.9	5.5	5.8	5.6	5.95
Price/earnings per share	20.0	22.1	18.0	19.0	19.78
Price/cash flow per share	11.8	13.0	10.5	11.0	11.58

Based on pre-acquisition prices of \$20 for Jones Foods, \$26 for Dale, Inc., \$35 for Hill Brands, and \$40 for Lane Co., the mean takeover premium for Flavoring would be *closest* to:

- A) 12.50%.
- B) 15.25%.
- C) 18.10%.

Question #24 of 60

Question ID: 691735

Fashion, Inc., is a major U.S. distributor of high-quality women's jewelry and accessories. The company's growth in recent years has been moderately above the industry average. However, competition is intensifying as a number of overseas competitors have entered this mature market. Although Fashion has been a publicly held company for many years, members of senior management and their families control 20% of the outstanding common stock. Martin Silver, the chief executive officer, has been under intense pressure from both internal and external large shareholders to find ways to increase the company's future growth.

company's future growth.

Silver has consulted with the company's investment bankers concerning possible merger targets. The most promising merger target is Flavoring International, a distributor of a broad line of gourmet spices in the United States and numerous other countries. In recent years, Flavoring's earnings growth rate has been above competitors' and also has exceeded Fashion's experience. Superior income growth is projected to continue over at least the next five years. Silver is impressed with the appeal of the company's products to upscale customers, its strong operating and financial performance, and Flavoring's dynamic management team. He is contemplating retirement in three years and believes that Flavoring's younger, more aggressive senior managers could boost the combined company's growth through increasing Fashion's operating efficiency and expanding Fashion's product line in countries outside the United States. Alan Smith, who is Silver's key contact at the investment banking firm, indicates that a key appeal of this merger to Flavoring would be Fashion's greater financial flexibility and access to lower cost sources of financing for expansion of its products in new geographic areas. Fashion has a very attractive performance based stock option plan. Flavoring's incentive plan is entirely based on cash compensation for achieving performance goals. Additionally, the 80% of Fashion's stock not controlled by management interests is very widely held and trades actively. Flavoring became a publicly held company three years ago and doesn't trade as actively.

Silver has asked Smith to prepare a report summarizing key points favoring the acquisition and an acceptable acquisition price. In preparing his report, Smith relies on the following financial data on Fashion, Flavoring, and four recently acquired food and beverage companies.

Exhibit 1: Financial and Market Data for Fashion, Inc. and Flavoring International

<i>Financial/Price Data</i>	<i>Fashion</i>	<i>Flavoring</i>
Sales	\$400 million	\$105 million
Net income	\$80 million	\$22 million
Cash flow	\$140 million	\$42 million
Book value	\$320 million	\$72 million
Number of common shares outstanding	50 million	20 million
Current market price of common stock	\$30.50	\$20.00
Recent market price range	\$34-26	\$22-18

Exhibit 2: Transaction Data for Food and Beverage Industry

<i>Valuation Variables</i>	<i>Jones Foods</i>	<i>Dale, Inc.</i>	<i>Hill Brands</i>	<i>Lane Co.</i>	<i>Mean Multiple</i>
Acquisition stock price	\$24	\$32	\$40	\$46	-
Price/sales per share	5.0	3.7	4.0	3.8	4.13
Price/book value per share	6.9	5.5	5.8	5.6	5.95
Price/earnings per share	20.0	22.1	18.0	19.0	19.78
Price/cash flow per share	11.8	13.0	10.5	11.0	11.58

To justify his use of the comparable transaction approach to establish a fair acquisition for Flavoring, Smith would like to

conclude his report with the most important reason for choosing this approach. Which of the following rationales would Smith

conclude his report with the most important reason for choosing this approach. Which of the following rationales would Smith *most likely* use?

- A) The fair acquisition price developed for Flavoring reflects a market based valuation approach, an advantage compared to discounted cash flow valuations, which are based on assumptions that do not incorporate market valuations.
- B) The acquisition prices for recently acquired companies provide a reasonable approximation of their realistic intrinsic values.
- C) The fair acquisition price developed for Flavoring is a realistic estimate of potential value to Fashion given that forecasts of future performance are unavailable.

Question #25 of 60

Question ID: 691730

Use the following information to answer Questions 85 through 90.

James Kelley is the CFO of X-Sport, Inc., a manufacturer of high-end outdoor sporting equipment. Using both debt and equity, X-Sport has been acquiring small competitor companies rather rapidly over the past few years, leading Kelley to believe that the firm's capital structure may have drifted from its optimal mix. Kelley has been asked by the board of directors to evaluate the situation and provide a presentation that includes details of the firm's capital structure as well as a risk assessment. In order to assist with his analysis, Kelley has collected information on the current financial situation of X-Sport. He has also projected the financial information for alternative financing plans. This information is presented in Exhibit 1.

Exhibit 1

	X-Sport, Inc.					Industry Average
	Current	Plan A	Plan B	Plan C	Plan D	
Debt/equity	1.50	2.33	1.86	1.22	0.82	1.27
K_d (after-tax)	5.0%	8.5%	6.2%	4.4%	3.9%	5.9%
K_e	12.0%	16.0%	13.5%	11.2%	10.9%	12.8%
Expected EPS	\$5.67	\$6.00	\$6.33	\$5.47	\$4.89	\$6.31
Payout ratio	45%					42%
Growth rate	6.1%					5.9%
Stock price	\$43					

After carefully analyzing the data, Kelley writes his analysis and proposal and submits the report to Richard Haywood, the chairman and CEO of X-Sport. Excerpts from the analysis and proposal follow:

- In selecting a refinancing plan, we must not push our leverage ratio too high. An overly aggressive leverage ratio will likely cause debt rating agencies to downgrade our debt rating from its current Baa rating, causing our cost of debt to rise dramatically. This effect is explained using the static trade-off capital structure theory, which states that if our debt usage

becomes high enough, the marginal increase in the interest tax shield will be more than the marginal increase in the costs of financial distress. However, using some additional leverage will benefit the company by reducing the net agency costs of equity required to align the interests of X-Sport management with its shareholders.

- In the event that X-Sport decides to proceed with a recapitalization plan, I recommend Plan D because it is the most consistent with the shareholders' interests.

Haywood reviews the report and calls Kelley into his office to discuss the proposal. Haywood suggests that Plan B would be the most appropriate choice for adjusting X-Sport's capital structure. Before Kelley can argue, however, the two are interrupted by a previously scheduled meeting with a supplier.

Haywood takes Kelley's data and proposes to the board of directors that X-Sport pursue one of three alternatives to restructure the company. The first alternative is Plan B from Kelley's analysis. The second alternative involves separating GearTech, one of the companies acquired over the last few years, from the rest of the company by issuing new GearTech shares to X-Sport common shareholders. The third alternative involves creating a new company, Euro-Sport, out of the firm's European operations and selling 35% of the new Euro-Sport shares to the public while retaining 65% of the shares within X-Sport. After some persuading, Haywood convinces the 7-member board (two of whom were former executives at GearTech) to accept the second alternative, which he had favored from the beginning. The board puts together an announcement to its shareholders as well as the general public, detailing the terms and goals of the plan.

One of the board members, Michael Ponting, points out that there are several theories of optimal capital structure. Ponting makes the following statements:

Statement 1: Miller and Modigliani Proposition II (without taxes) states that cost of equity is not affected by capital structure changes.

Statement 2: Pecking order theory states that debt financing is preferable to all equity financing.

Statement 3: Static trade-off theory states that all firms have an optimal level of debt.

A group of shareholders, upset about the board's plan, submit a formal objection to X-Sport's board as well as to the SEC. In the objection, the shareholders state that the independence of the board has been compromised to the detriment of the company and its shareholders. The objection also states that:

- The value of X-Sport's common stock has been impaired as a result of the poor corporate governance system.
- The liability risk of X-Sport has increased due to the increased possibility of future transactions that benefit X-Sport's directors, without regard to the long-term interests of shareholders.
- The asset risk of X-Sport has increased due to the inability of investors to trust the GearTech financial disclosures necessary to value the division.

Using the information in Exhibit 1, calculate X-Sport's weighted average cost of capital for the optimal capital structure.

- A) 7.46%
- B) 7.75%.
- C) 8.76%.

Question #26 of 60

Question ID: 691727

James Kelley is the CFO of X-Sport, Inc., a manufacturer of high-end outdoor sporting equipment. Using both debt and equity, X-Sport has been acquiring small competitor companies rather rapidly over the past few years, leading Kelley to believe that the firm's capital structure may have drifted from its optimal mix. Kelley has been asked by the board of directors to evaluate the situation and provide a presentation that includes details of the firm's capital structure as well as a risk assessment. In order to assist with his analysis, Kelley has collected information on the current financial situation of X-Sport. He has also projected the financial information for alternative financing plans. This information is presented in Exhibit 1.

Exhibit 1

	X-Sport, Inc.					Industry Average
	Current	Plan A	Plan B	Plan C	Plan D	
Debt/equity	1.50	2.33	1.86	1.22	0.82	1.27
K_d (after-tax)	5.0%	8.5%	6.2%	4.4%	3.9%	5.9%
K_e	12.0%	16.0%	13.5%	11.2%	10.9%	12.8%
Expected EPS	\$5.67	\$6.00	\$6.33	\$5.47	\$4.89	\$6.31
Payout ratio	45%					42%
Growth rate	6.1%					5.9%
Stock price	\$43					

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- In the event that X-Sport decides to proceed with a recapitalization plan, I recommend Plan D because it is the most consistent with the shareholders' interests.

Haywood reviews the report and calls Kelley into his office to discuss the proposal. Haywood suggests that Plan B would be the most appropriate choice for adjusting X-Sport's capital structure. Before Kelley can argue, however, the two are interrupted by a previously scheduled meeting with a supplier.

Haywood takes Kelley's data and proposes to the board of directors that X-Sport pursue one of three alternatives to restructure the company. The first alternative is Plan B from Kelley's analysis. The second alternative involves separating GearTech, one of the companies acquired over the last few years, from the rest of the company by issuing new GearTech shares to X-Sport common shareholders. The third alternative involves creating a new company, Euro-Sport, out of the firm's

European operations and selling 35% of the new Euro-Sport shares to the public while retaining 65% of the shares within X-Sport. After some persuading, Haywood convinces the 7-member board (two of whom were former executives at GearTech) to accept the second alternative, which he had favored from the beginning. The board puts together an announcement to its shareholders as well as the general public, detailing the terms and goals of the plan.

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- The value of X-Sport's common stock has been impaired as a result of the poor corporate governance system.
- The liability risk of X-Sport has increased due to the increased possibility of future transactions that benefit X-Sport's directors, without regard to the long-term interests of shareholders.
- The asset risk of X-Sport has increased due to the inability of investors to trust the GearTech financial disclosures necessary to value the division.

Determine whether Kelley's report is correct with regard to the statements made about the static trade-off theory of capital structure and the net agency costs of equity.

- A) Kelley is only correct with respect to the static trade-off theory.
- B) Kelley is only correct with respect to the net agency cost of equity.
- C) Kelley is incorrect with respect to the static trade-off theory and the net agency cost of equity.

Question #27 of 60

Question ID: 691728

James Kelley is the CFO of X-Sport, Inc., a manufacturer of high-end outdoor sporting equipment. Using both debt and equity, X-Sport has been acquiring small competitor companies rather rapidly over the past few years, leading Kelley to believe that the firm's capital structure may have drifted from its optimal mix. Kelley has been asked by the board of directors to evaluate the situation and provide a presentation that includes details of the firm's capital structure as well as a risk assessment. In order to assist with his analysis, Kelley has collected information on the current financial situation of X-Sport. He has also projected the financial information for alternative financing plans. This information is presented in Exhibit 1.

Exhibit 1

	X-Sport, Inc.					Industry Average
	Current	Plan A	Plan B	Plan C	Plan D	
Debt/equity	1.50	2.33	1.86	1.22	0.82	1.27
K_d (after-tax)	5.0%	8.5%	6.2%	4.4%	3.9%	5.9%
K_e	12.0%	16.0%	13.5%	11.2%	10.9%	12.8%
Expected EPS	\$5.67	\$6.00	\$6.33	\$5.47	\$4.89	\$6.31
Payout ratio	45%					42%
Growth rate	6.1%					5.9%
Stock price	\$43					

After carefully analyzing the data, Kelley writes his analysis and proposal and submits the report to Richard Haywood, the chairman and CEO of X-Sport. Excerpts from the analysis and proposal follow:

- In selecting a refinancing plan, we must not push our leverage ratio too high. An overly aggressive leverage ratio will likely cause debt rating agencies to downgrade our debt rating from its current Baa rating, causing our cost of debt to rise dramatically. This effect is explained using the static trade-off capital structure theory, which states that if our debt usage becomes high enough, the marginal increase in the interest tax shield will be more than the marginal increase in the costs of financial distress. However, using some additional leverage will benefit the company by reducing the net agency costs of equity required to align the interests of X-Sport management with its shareholders.
- In the event that X-Sport decides to proceed with a recapitalization plan, I recommend Plan D because it is the most consistent with the shareholders' interests.

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Haywood takes Kelley's data and proposes to the board of directors that X-Sport pursue one of three alternatives to restructure the company. The first alternative is Plan B from Kelley's analysis. The second alternative involves separating GearTech, one of the companies acquired over the last few years, from the rest of the company by issuing new GearTech shares to X-Sport common shareholders. The third alternative involves creating a new company, Euro-Sport, out of the firm's European operations and selling 35% of the new Euro-Sport shares to the public while retaining 65% of the shares within X-Sport. After some persuading, Haywood convinces the 7-member board (two of whom were former executives at GearTech) to accept the second alternative, which he had favored from the beginning. The board puts together an announcement to its shareholders as well as the general public, detailing the terms and goals of the plan.

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financing.

Statement 3: Static trade-off theory states that all firms have an optimal level of debt.

A group of shareholders, upset about the board's plan, submit a formal objection to X-Sport's board as well as to the SEC. In the objection, the shareholders state that the independence of the board has been compromised to the detriment of the company and its shareholders. The objection also states that:

- The value of X-Sport's common stock has been impaired as a result of the poor corporate governance system.
- The liability risk of X-Sport has increased due to the increased possibility of future transactions that benefit X-Sport's directors, without regard to the long-term interests of shareholders.
- The asset risk of X-Sport has increased due to the inability of investors to trust the GearTech financial disclosures necessary to value the division.

Which of the following *best* explains the difference between X-Sport's current cost of debt and the cost of debt associated with Plan A?

- A) Decreased tax advantage with Plan A.
- B) Increased liquidity risk for Plan A bond purchasers.
- C) Increased probability of bankruptcy with Plan A.

Question #28 of 60

Question ID: 691729

James Kelley is the CFO of X-Sport, Inc., a manufacturer of high-end outdoor sporting equipment. Using both debt and equity, X-Sport has been acquiring small competitor companies rather rapidly over the past few years, leading Kelley to believe that the firm's capital structure may have drifted from its optimal mix. Kelley has been asked by the board of directors to evaluate the situation and provide a presentation that includes details of the firm's capital structure as well as a risk assessment. In order to assist with his analysis, Kelley has collected information on the current financial situation of X-Sport. He has also projected the financial information for alternative financing plans. This information is presented in Exhibit 1.

Exhibit 1

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K_d (after-tax)	5.0%	8.5%	6.2%	4.4%	3.9%	5.9%
K_e	12.0%	16.0%	13.5%	11.2%	10.9%	12.8%
Expected EPS	\$5.67	\$6.00	\$6.33	\$5.47	\$4.89	\$6.31
Payout ratio	45%					42%

Growth rate	6.1%					5.9%
Stock price	\$43					

After carefully analyzing the data, Kelley writes his analysis and proposal and submits the report to Richard Haywood, the chairman and CEO of X-Sport. Excerpts from the analysis and proposal follow:

- In selecting a refinancing plan, we must not push our leverage ratio too high. An overly aggressive leverage ratio will likely cause debt rating agencies to downgrade our debt rating from its current Baa rating, causing our cost of debt to rise dramatically. This effect is explained using the static trade-off capital structure theory, which states that if our debt usage becomes high enough, the marginal increase in the interest tax shield will be more than the marginal increase in the costs of financial distress. However, using some additional leverage will benefit the company by reducing the net agency costs of equity required to align the interests of X-Sport management with its shareholders.
- In the event that X-Sport decides to proceed with a recapitalization plan, I recommend Plan D because it is the most consistent with the shareholders' interests.

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- The value of X-Sport's common stock has been impaired as a result of the poor corporate governance system.
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- The asset risk of X-Sport has increased due to the inability of investors to trust the GearTech financial disclosures necessary to value the division.

Which of the statements made by Ponting is correct?

- A) Only Statement 1 is correct.
- B) Only Statement 2 is correct.
- C) Only Statement 3 is correct.

Question #29 of 60

Question ID: 691738

James Kelley is the CFO of X-Sport, Inc., a manufacturer of high-end outdoor sporting equipment. Using both debt and equity, X-Sport has been acquiring small competitor companies rather rapidly over the past few years, leading Kelley to believe that the firm's capital structure may have drifted from its optimal mix. Kelley has been asked by the board of directors to evaluate the situation and provide a presentation that includes details of the firm's capital structure as well as a risk assessment. In order to assist with his analysis, Kelley has collected information on the current financial situation of X-Sport. He has also projected the financial information for alternative financing plans. This information is presented in Exhibit 1.

Exhibit 1

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Expected EPS	\$5.67	\$6.00	\$6.33	\$5.47	\$4.89	\$6.31
Payout ratio	45%					42%
Growth rate	6.1%					5.9%
Stock price	\$43					

After carefully analyzing the data, Kelley writes his analysis and proposal and submits the report to Richard Haywood, the chairman and CEO of X-Sport. Excerpts from the analysis and proposal follow:

- In selecting a refinancing plan, we must not push our leverage ratio too high. An overly aggressive leverage ratio will likely cause debt rating agencies to downgrade our debt rating from its current Baa rating, causing our cost of debt to rise dramatically. This effect is explained using the static trade-off capital structure theory, which states that if our debt usage becomes high enough, the marginal increase in the interest tax shield will be more than the marginal increase in the costs of financial distress. However, using some additional leverage will benefit the company by reducing the net agency costs of equity required to align the interests of X-Sport management with its shareholders.
- In the event that X-Sport decides to proceed with a recapitalization plan, I recommend Plan D because it is the most consistent with the shareholders' interests.

Haywood reviews the report and calls Kelley into his office to discuss the proposal. Haywood suggests that Plan B would be the most appropriate choice for adjusting X-Sport's capital structure. Before Kelley can argue, however, the two are interrupted by a previously scheduled meeting with a supplier.

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- The asset risk of X-Sport has increased due to the inability of investors to trust the GearTech financial disclosures necessary to value the division.

Which of the following statements with regard to the alternative plans proposed to X-Sport's board of directors by Haywood is correct?

- A)** The GearTech plan is an example of a spin-off transaction, while the Euro-Sport plan is an example of a carve-out transaction.
- B)** The GearTech plan is an example of a carve-out transaction, while the Euro-Sport plan is an example of a spin-off transaction.
- C)** Both the GearTech plan and the Euro-Sport plans are examples of spin-off transactions.

Question #30 of 60

Question ID: 691731

James Kelley is the CFO of X-Sport, Inc., a manufacturer of high-end outdoor sporting equipment. Using both debt and equity, X-Sport has been acquiring small competitor companies rather rapidly over the past few years, leading Kelley to believe that the firm's capital structure may have drifted from its optimal mix. Kelley has been asked by the board of directors to evaluate the situation and provide a presentation that includes details of the firm's capital structure as well as a risk assessment. In order to assist with his analysis, Kelley has collected information on the current financial situation of X-Sport. He has also projected the financial information for alternative financing plans. This information is presented in Exhibit 1.

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- The asset risk of X-Sport has increased due to the inability of investors to trust the GearTech financial disclosures necessary to value the division.

Evaluate the three statements in the shareholders' formal objection submitted to X-Sport's board of directors. The objection is correct with regard to:

- A) asset risk.
- B) liability risk.
- C) the value impact.

Question #31 of 60

Question ID: 691739

Use the following information to answer Questions 91 through 96.

Marie Williams, CFA, and David Pacious, CFA, are portfolio managers for Stillwell Managers. Williams and Pacious are attending a conference held by Henri Financial Education on the fundamentals of valuation for common stock, preferred stock, and other assets.

During the conference, the presenter uses an example of four different companies to illustrate the valuation of common stock from the perspective of a minority shareholder.

- Firm A is a noncyclical consumer products firm with a 50-year history. The firm pays a \$1.80 dividend per share and attempts to increase dividends by 4% a year. Earnings and dividends have steadily increased for the past 20 years.

- Firm B is a technology firm. It has never paid a dividend and does not expect to in the near future. Furthermore, due to large investments in new factories and equipment, the firm is not expected to generate positive free cash flow in the foreseeable future.
- Firm C is an industrial firm with currently very little competition and a dividend growth rate of 9% a year. However, the profits in its product market have started to attract competitors and it is expected that Firm C's profits will slowly decline such that the dividend growth steadily falls each year until it reaches a growth rate of 4% a year.
- Firm D is a pharmaceutical firm that is currently enjoying high profits and paying dividends. However, the firm's strongest selling drug is coming off patent in three years. With no other drugs in the pipeline, the firm's dividend growth rate is expected to drop abruptly in three years and settle at a lower growth rate.

The next day, Pacious decides to put what he learned into practice. The stock he is valuing, Maple Goods and Services, currently pays a dividend of \$3.00. The dividend growth rate is 25% and is expected to steadily decline over the next eight years to a stable rate of 7% thereafter. Given its risk, Pacious estimates that the required return is 15%.

Williams analyzes the value of Mataka Plastics stock. Its dividend is expected to grow at a rate of 18% for the next four years, after which it will grow at 4%. This year's dividend is \$5.00 and Williams estimates the required return at 15%.

From the seminar, Pacious learned that a firm's health can be gauged by the present value of its future investment opportunities (PVGO). Tackling a calculation, he uses the following example for Wood Athletic Supplies:

Stock price	\$90.00
Current earnings	\$5.50
Expected earnings	\$6.00
Required return on stock	15%

Pacious and Williams discuss the characteristics of firms in various stages of growth, where firms experience an initial growth phase, a transitional phase, and a maturity phase in their life. They both agree that the Gordon Growth Model is not always appropriate. Pacious makes the following statements.

Statement 1: For firms in the initial growth phase, earnings are rapidly increasing, there are little or no dividends, and there is heavy reinvestment. The return on equity is, however, higher than the required return on the stock, the free cash flows to equity are positive, and the profit margin is high.

Statement 2: When estimating the terminal value in the 3-stage dividend growth model, it can be estimated using the Gordon Growth Model or a price-multiple approach.

.....

Which of the following *best* describes the appropriate valuation models for the Henri presentation scenarios?

- A)** Firm A should be valued using a free cash flow model. Firm B should be valued using a free cash flow model.
- B)** Firm A should be valued using a dividend discount model. Firm B should be valued using a residual income model.
- C)** Firm A can be valued using either a free cash flow model or a dividend discount model. Firm B should be valued using a residual income model.

Question #32 of 60

Question ID: 691741

Marie Williams, CFA, and David Pacious, CFA, are portfolio managers for Stillwell Managers. Williams and Pacious are attending a conference held by Henri Financial Education on the fundamentals of valuation for common stock, preferred stock, and other assets.

During the conference, the presenter uses an example of four different companies to illustrate the valuation of common stock from the perspective of a minority shareholder.

- Firm A is a noncyclical consumer products firm with a 50-year history. The firm pays a \$1.80 dividend per share and attempts to increase dividends by 4% a year. Earnings and dividends have steadily increased for the past 20 years.
- Firm B is a technology firm. It has never paid a dividend and does not expect to in the near future. Furthermore, due to large investments in new factories and equipment, the firm is not expected to generate positive free cash flow in the foreseeable future.
- Firm C is an industrial firm with currently very little competition and a dividend growth rate of 9% a year. However, the profits in its product market have started to attract competitors and it is expected that Firm C's profits will slowly decline such that the dividend growth steadily falls each year until it reaches a growth rate of 4% a year.
- Firm D is a pharmaceutical firm that is currently enjoying high profits and paying dividends. However, the firm's strongest selling drug is coming off patent in three years. With no other drugs in the pipeline, the firm's dividend growth rate is expected to drop abruptly in three years and settle at a lower growth rate.

The next day, Pacious decides to put what he learned into practice. The stock he is valuing, Maple Goods and Services, currently pays a dividend of \$3.00. The dividend growth rate is 25% and is expected to steadily decline over the next eight years to a stable rate of 7% thereafter. Given its risk, Pacious estimates that the required return is 15%.

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From the seminar, Pacious learned that a firm's health can be gauged by the present value of its future investment opportunities (PVGO). Tackling a calculation, he uses the following example for Wood Athletic Supplies:

Stock price	\$90.00
Current earnings	\$5.50
Expected earnings	\$6.00
Required return on stock	15%

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Statement 2: When estimating the terminal value in the 3-stage dividend growth model, it can be estimated using the Gordon Growth Model or a price-multiple approach.

Which of the following *best* describes the appropriate valuation techniques for the Henri presentation scenarios?

- A) Firm C should be valued using a 2-stage dividend discount model. Firm D should be valued using an H dividend discount model.
 - B) Firm C should be valued using an H dividend discount model. Firm D should be valued using a 2-stage dividend discount model.
 - C) Both Firms C and D should be valued using the H dividend discount model.
-

Question #33 of 60

Question ID: 691743

Marie Williams, CFA, and David Pacious, CFA, are portfolio managers for Stillwell Managers. Williams and Pacious are attending a conference held by Henri Financial Education on the fundamentals of valuation for common stock, preferred stock, and other assets.

During the conference, the presenter uses an example of four different companies to illustrate the valuation of common stock from the perspective of a minority shareholder.

- Firm A is a noncyclical consumer products firm with a 50-year history. The firm pays a \$1.80 dividend per share and attempts to increase dividends by 4% a year. Earnings and dividends have steadily increased for the past 20 years.
- Firm B is a technology firm. It has never paid a dividend and does not expect to in the near future. Furthermore, due to large investments in new factories and equipment, the firm is not expected to generate positive free cash flow in the foreseeable future.
- Firm C is an industrial firm with currently very little competition and a dividend growth rate of 9% a year. However, the profits in its product market have started to attract competitors and it is expected that Firm C's profits will slowly decline such that the dividend growth steadily falls each year until it reaches a growth rate of 4% a year.
- Firm D is a pharmaceutical firm that is currently enjoying high profits and paying dividends. However, the firm's strongest selling drug is coming off patent in three years. With no other drugs in the pipeline, the firm's dividend growth rate is expected to drop abruptly in three years and settle at a lower growth rate.

The next day, Pacious decides to put what he learned into practice. The stock he is valuing, Maple Goods and Services, currently pays a dividend of \$3.00. The dividend growth rate is 25% and is expected to steadily decline over the next eight years to a stable rate of 7% thereafter. Given its risk, Pacious estimates that the required return is 15%.

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From the seminar, Pacious learned that a firm's health can be gauged by the present value of its future investment opportunities (PVGO). Tackling a calculation, he uses the following example for Wood Athletic Supplies:

Stock price	\$90.00
Current earnings	\$5.50
Expected earnings	\$6.00
Required return on stock	15%

Pacious and Williams discuss the characteristics of firms in various stages of growth, where firms experience an initial growth phase, a transitional phase, and a maturity phase in their life. They both agree that the Gordon Growth Model is not always appropriate. Pacious makes the following statements.

Statement 1: For firms in the initial growth phase, earnings are rapidly increasing, there are little or no dividends, and there is heavy reinvestment. The return on equity is, however, higher than the required return on the stock, the free cash flows to equity are positive, and the profit margin is high.

Statement 2: When estimating the terminal value in the 3-stage dividend growth model, it can be estimated using the Gordon Growth Model or a price-multiple approach.

.....

Which of the following is *closest* to the current value for Maple Goods and Services stock?

- A) \$15.90.
- B) \$49.13.
- C) \$67.13.

Question #34 of 60

Question ID: 691744

Marie Williams, CFA, and David Pacious, CFA, are portfolio managers for Stillwell Managers. Williams and Pacious are attending a conference held by Henri Financial Education on the fundamentals of valuation for common stock, preferred stock, and other assets.

During the conference, the presenter uses an example of four different companies to illustrate the valuation of common stock from the perspective of a minority shareholder.

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- Firm C is an industrial firm with currently very little competition and a dividend growth rate of 9% a year. However, the profits in its product market have started to attract competitors and it is expected that Firm C's profits will slowly decline such that the dividend growth steadily falls each year until it reaches a growth rate of 4% a year.
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expected to drop abruptly in three years and settle at a lower growth rate.

The next day, Pacious decides to put what he learned into practice. The stock he is valuing, Maple Goods and Services, currently pays a dividend of \$3.00. The dividend growth rate is 25% and is expected to steadily decline over the next eight years to a stable rate of 7% thereafter. Given its risk, Pacious estimates that the required return is 15%.

Williams analyzes the value of Mataka Plastics stock. Its dividend is expected to grow at a rate of 18% for the next four years, after which it will grow at 4%. This year's dividend is \$5.00 and Williams estimates the required return at 15%.

From the seminar, Pacious learned that a firm's health can be gauged by the present value of its future investment opportunities (PVGGO). Tackling a calculation, he uses the following example for Wood Athletic Supplies:

Stock price	\$90.00
Current earnings	\$5.50
Expected earnings	\$6.00
Required return on stock	15%

Pacious and Williams discuss the characteristics of firms in various stages of growth, where firms experience an initial growth phase, a transitional phase, and a maturity phase in their life. They both agree that the Gordon Growth Model is not always appropriate. Pacious makes the following statements.

Statement 1: For firms in the initial growth phase, earnings are rapidly increasing, there are little or no dividends, and there is heavy reinvestment. The return on equity is, however, higher than the required return on the stock, the free cash flows to equity are positive, and the profit margin is high.

Statement 2: When estimating the terminal value in the 3-stage dividend growth model, it can be estimated using the Gordon Growth Model or a price-multiple approach.

Which of the following is *closest* to the current value for Mataka Plastics stock?

- A) \$62.49.
- B) \$73.73.
- C) \$81.60.

Question #35 of 60

Question ID: 691740

Marie Williams, CFA, and David Pacious, CFA, are portfolio managers for Stillwell Managers. Williams and Pacious are attending a conference held by Henri Financial Education on the fundamentals of valuation for common stock, preferred stock, and other assets.

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from the perspective of a minority shareholder.

- Firm A is a noncyclical consumer products firm with a 50-year history. The firm pays a \$1.80 dividend per share and attempts to increase dividends by 4% a year. Earnings and dividends have steadily increased for the past 20 years.
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The next day, Pacious decides to put what he learned into practice. The stock he is valuing, Maple Goods and Services, currently pays a dividend of \$3.00. The dividend growth rate is 25% and is expected to steadily decline over the next eight years to a stable rate of 7% thereafter. Given its risk, Pacious estimates that the required return is 15%.

Williams analyzes the value of Mataka Plastics stock. Its dividend is expected to grow at a rate of 18% for the next four years, after which it will grow at 4%. This year's dividend is \$5.00 and Williams estimates the required return at 15%.

From the seminar, Pacious learned that a firm's health can be gauged by the present value of its future investment opportunities (PVGO). Tackling a calculation, he uses the following example for Wood Athletic Supplies:

Stock price	\$90.00
Current earnings	\$5.50
Expected earnings	\$6.00
Required return on stock	15%

Pacious and Williams discuss the characteristics of firms in various stages of growth, where firms experience an initial growth phase, a transitional phase, and a maturity phase in their life. They both agree that the Gordon Growth Model is not always appropriate. Pacious makes the following statements.

Statement 1: For firms in the initial growth phase, earnings are rapidly increasing, there are little or no dividends, and there is heavy reinvestment. The return on equity is, however, higher than the required return on the stock, the free cash flows to equity are positive, and the profit margin is high.

Statement 2: When estimating the terminal value in the 3-stage dividend growth model, it can be estimated using the Gordon Growth Model or a price-multiple approach.

Which of the following is *closest* to the percent of Wood Athletic Supplies leading P/E related to PVGO?

- A) 56%.
- B) 59%.
- C) 69%.

Question #36 of 60

Question ID: 691742

Marie Williams, CFA, and David Pacious, CFA, are portfolio managers for Stillwell Managers. Williams and Pacious are attending a conference held by Henri Financial Education on the fundamentals of valuation for common stock, preferred stock, and other assets.

During the conference, the presenter uses an example of four different companies to illustrate the valuation of common stock from the perspective of a minority shareholder.

- Firm A is a noncyclical consumer products firm with a 50-year history. The firm pays a \$1.80 dividend per share and attempts to increase dividends by 4% a year. Earnings and dividends have steadily increased for the past 20 years.
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The next day, Pacious decides to put what he learned into practice. The stock he is valuing, Maple Goods and Services, currently pays a dividend of \$3.00. The dividend growth rate is 25% and is expected to steadily decline over the next eight years to a stable rate of 7% thereafter. Given its risk, Pacious estimates that the required return is 15%.

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From the seminar, Pacious learned that a firm's health can be gauged by the present value of its future investment opportunities (PVGO). Tackling a calculation, he uses the following example for Wood Athletic Supplies:

Stock price	\$90.00
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Expected earnings	\$6.00
Required return on stock	15%

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Statement 2: When estimating the terminal value in the 3-stage dividend growth model, it can be estimated using the Gordon Growth Model or a price-multiple approach.

Regarding Pacious's statements on the stages of growth and the Gordon Growth Model, are both statements correct?

- A) Yes.
- B) No, only Statement 2 is correct.
- C) No, both statements are incorrect.

Question #37 of 60

Question ID: 691746

Use the following information to answer Questions 97 through 102.

Asante Bizou is an equity analyst for Alpha, Inc., a boutique consulting firm in San Jose, CA. Alpha is providing consulting services to Prizm's board in evaluating the performance of Prizm's management. Bizou reviews Prizm's key financial data for the past three years.

Selected information from Prizm's financial statements is given in Exhibit 1.

Exhibit 1: Selected Prizm Financial Data

<i>Income Statement</i>	20X4	20X5	20X6
	\$m	\$m	\$m
Sales	40.2	42.3	43.9
Cost of goods sold	(11.6)	(12.3)	(12.8)
Gross profit	28.6	30.0	31.1
Administrative expenses	(10.0)	(10.0)	(3.0)
Earnings before interest and tax	18.6	20.0	28.1
Interest	(6.3)	(6.3)	(4.2)
Earnings before tax	12.3	13.7	23.9
Tax	(5.1)	(5.6)	(11.4)
Net income	7.2	8.1	12.5
Dividends	(3.0)	(3.1)	(3.2)
Retained income	4.2	5.0	9.3

Exhibit 1: Selected Prizm Financial Data (continued)

<i>Balance Sheet at 31 December</i>	20X3	20X4	20X5	20X6
	\$m	\$m	\$m	\$m
Working capital	24.0	25.6	27.2	32.4
Fixed assets	76.0	78.6	82.0	78.1
Total assets	100.0	104.2	109.2	110.5

Liabilities	24.0	24.0	24.0	16.0
Common stock	20.0	20.0	20.0	20.0
Additional paid up capital	10.0	10.0	10.0	10.0
Retained income	<u>46.0</u>	<u>50.2</u>	<u>55.2</u>	<u>64.5</u>
	<u>100.0</u>	<u>104.2</u>	<u>109.2</u>	<u>110.5</u>

Market value of equity (31 December)	167	203	199	145
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Other information:

- Beta of firm = 1.
- Debtholders' required rate of return: 5%.
- Equityholders' required rate of return: 15%.
- After tax WACC: 12.5%.
- Tax rate: 45%.

Notes:

1. Depreciation included in cost of goods sold and administrative expenses is 12m, 10.5m, and 9.6m for 20X6, 20X5, and 20X4, respectively.
2. \$8m of debt was redeemed at the end of 20X6.
3. Other than the debt redeemed in 20X6, Prizm's liabilities consist mostly of long-term debt valued approximately at book value.
4. Replacement value of assets is roughly equal to book value minus 4%.

.....

In computing EVA®, which of the following adjustments made by an analyst would be *least appropriate*?

- A) Add LIFO reserve to total capital.
- B) Expense R&D instead of capitalizing it.
- C) Eliminate deferred taxes and consider only cash taxes as an expense.

Question #38 of 60

Question ID: 691747

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Exhibit 1: Selected Prizm Financial Data

<i>Income Statement</i>	20X4	20X5	20X6
	\$m	\$m	\$m
Sales	40.2	42.3	43.9
Cost of goods sold	<u>(11.6)</u>	<u>(12.3)</u>	<u>(12.8)</u>
Gross profit	28.6	30.0	31.1
Administrative expenses	<u>(10.0)</u>	<u>(10.0)</u>	<u>(3.0)</u>
Earnings before interest and tax	18.6	20.0	28.1
Interest	<u>(6.3)</u>	<u>(6.3)</u>	<u>(4.2)</u>
Earnings before tax	12.3	13.7	23.9
Tax	<u>(5.1)</u>	<u>(5.6)</u>	<u>(11.4)</u>
Net income	7.2	8.1	12.5
Dividends	<u>(3.0)</u>	<u>(3.1)</u>	<u>(3.2)</u>
Retained income	4.2	5.0	9.3

Exhibit 1: Selected Prizm Financial Data (continued)

<i>Balance Sheet at 31 December</i>	20X3	20X4	20X5	20X6
	\$m	\$m	\$m	\$m
Working capital	24.0	25.6	27.2	32.4
Fixed assets	<u>76.0</u>	<u>78.6</u>	<u>82.0</u>	<u>78.1</u>
Total assets	<u>100.0</u>	<u>104.2</u>	<u>109.2</u>	<u>110.5</u>
Liabilities	24.0	24.0	24.0	16.0
Common stock	20.0	20.0	20.0	20.0
Additional paid up capital	10.0	10.0	10.0	10.0
Retained income	<u>46.0</u>	<u>50.2</u>	<u>55.2</u>	<u>64.5</u>
	<u>100.0</u>	<u>104.2</u>	<u>109.2</u>	<u>110.5</u>
Market value of equity (31 December)	167	203	199	145

Other information:

- Beta of firm = 1.
- Debtholders' required rate of return: 5%.
- Equityholders' required rate of return: 15%.
- After tax WACC: 12.5%.
- Tax rate: 45%.

Notes:

1. Depreciation included in cost of goods sold and administrative expenses is 12m, 10.5m, and 9.6m for 20X6, 20X5, and 20X4, respectively.

2. \$8m of debt was redeemed at the end of 20X6.

3. Other than the debt redeemed in 20X6, Prizm's liabilities consist mostly of long-term debt valued approximately at book value.
4. Replacement value of assets is roughly equal to book value minus 4%.

Prizm's EVA® for 20X6 is *closest* to:

- A) Negative \$1.3 million.
- B) Negative \$1.2 million.
- C) Positive \$1.8 million.

Question #39 of 60

Question ID: 693187

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Exhibit 1: Selected Prizm Financial Data

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Gross profit	28.6	30.0	31.1
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Earnings before interest and tax	18.6	20.0	28.1
Interest	<u>(6.3)</u>	<u>(6.3)</u>	<u>(4.2)</u>
Earnings before tax	12.3	13.7	23.9
Tax	<u>(5.1)</u>	<u>(5.6)</u>	<u>(11.4)</u>
Net income	7.2	8.1	12.5
Dividends	<u>(3.0)</u>	<u>(3.1)</u>	<u>(3.2)</u>
Retained income	4.2	5.0	9.3

Exhibit 1: Selected Prizm Financial Data (continued)

<i>Balance Sheet at 31 December</i>	20X3	20X4	20X5	20X6
	\$m	\$m	\$m	\$m
Working capital	24.0	25.6	27.2	32.4
Fixed assets	<u>76.0</u>	<u>78.6</u>	<u>82.0</u>	<u>78.1</u>
Total assets	100.0	104.2	109.2	110.5

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Liabilities	24.0	24.0	24.0	16.0
Common stock	20.0	20.0	20.0	20.0
Additional paid up capital	10.0	10.0	10.0	10.0
Retained income	<u>46.0</u>	<u>50.2</u>	<u>55.2</u>	<u>64.5</u>
	<u>100.0</u>	<u>104.2</u>	<u>109.2</u>	<u>110.5</u>

Market value of equity (31 December)	167	203	199	145
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Other information:

- Beta of firm = 1.
- Debtholders' required rate of return: 5%.
- Equityholders' required rate of return: 15%.
- After tax WACC: 12.5%.
- Tax rate: 45%.

Notes:

1. Depreciation included in cost of goods sold and administrative expenses is 12m, 10.5m, and 9.6m for 20X6, 20X5, and 20X4, respectively.
2. \$8m of debt was redeemed at the end of 20X6.
3. Other than the debt redeemed in 20X6, Prizm's liabilities consist mostly of long-term debt valued approximately at book value.
4. Replacement value of assets is roughly equal to book value minus 4%.

Prizm's residual income for 20X6 is *closest* to:

- A) -\$0.3 million.
- B) \$0.7 million.
- C) \$2.5 million.

Question #40 of 60

Question ID: 693188

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Gross profit	28.6	30.0	31.1
Administrative expenses	<u>(10.0)</u>	<u>(10.0)</u>	<u>(3.0)</u>
Earnings before interest and tax	18.6	20.0	28.1
Interest	<u>(6.3)</u>	<u>(6.3)</u>	<u>(4.2)</u>
Earnings before tax	12.3	13.7	23.9
Tax	<u>(5.1)</u>	<u>(5.6)</u>	<u>(11.4)</u>
Net income	7.2	8.1	12.5
Dividends	<u>(3.0)</u>	<u>(3.1)</u>	<u>(3.2)</u>
Retained income	4.2	5.0	9.3

Exhibit 1: Selected Prizm Financial Data (continued)

<i>Balance Sheet at 31 December</i>	20X3	20X4	20X5	20X6
	\$m	\$m	\$m	\$m
Working capital	24.0	25.6	27.2	32.4
Fixed assets	<u>76.0</u>	<u>78.6</u>	<u>82.0</u>	<u>78.1</u>
Total assets	<u>100.0</u>	<u>104.2</u>	<u>109.2</u>	<u>110.5</u>
Liabilities	24.0	24.0	24.0	16.0
Common stock	20.0	20.0	20.0	20.0
Additional paid up capital	10.0	10.0	10.0	10.0
Retained income	<u>46.0</u>	<u>50.2</u>	<u>55.2</u>	<u>64.5</u>
	<u>100.0</u>	<u>104.2</u>	<u>109.2</u>	<u>110.5</u>
Market value of equity (31 December)	167	203	199	145

Other information:

- Beta of firm = 1.
- Debtholders' required rate of return: 5%.
- Equityholders' required rate of return: 15%.
- After tax WACC: 12.5%.
- Tax rate: 45%.

Notes:

1. Depreciation included in cost of goods sold and administrative expenses is 12m, 10.5m, and 9.6m for 20X6, 20X5, and 20X4, respectively.

2. \$8m of debt was redeemed at the end of 20X6.

2. \$8m of debt was redeemed at the end of 20X5.

3. Other than the debt redeemed in 20X6, Prizm's liabilities consist mostly of long-term debt valued approximately at book value.

4. Replacement value of assets is roughly equal to book value minus 4%.

Prizm's Market Value Added (MVA) as of fiscal year-end 20X6 is *closest* to:

- A) \$9.3 million
- B) \$12.5 million
- C) \$50.5 million

Question #41 of 60

Question ID: 691745

Asante Bizou is an equity analyst for Alpha, Inc., a boutique consulting firm in San Jose, CA. Alpha is providing consulting services to Prizm's board in evaluating the performance of Prizm's management. Bizou reviews Prizm's key financial data for the past three years.

Selected information from Prizm's financial statements is given in Exhibit 1.

Exhibit 1: Selected Prizm Financial Data

<i>Income Statement</i>	20X4	20X5	20X6
	\$m	\$m	\$m
Sales	40.2	42.3	43.9
Cost of goods sold	(11.6)	(12.3)	(12.8)
Gross profit	28.6	30.0	31.1
Administrative expenses	(10.0)	(10.0)	(3.0)
Earnings before interest and tax	18.6	20.0	28.1
Interest	(6.3)	(6.3)	(4.2)
Earnings before tax	12.3	13.7	23.9
Tax	(5.1)	(5.6)	(11.4)
Net income	7.2	8.1	12.5
Dividends	(3.0)	(3.1)	(3.2)
Retained income	4.2	5.0	9.3

Exhibit 1: Selected Prizm Financial Data (continued)

<i>Balance Sheet at 31 December</i>	20X3	20X4	20X5	20X6
	\$m	\$m	\$m	\$m
Working capital	24.0	25.6	27.2	32.4
Fixed assets	76.0	78.6	82.0	78.1

Total assets	<u>100.0</u>	<u>104.2</u>	<u>109.2</u>	<u>110.5</u>
Liabilities	24.0	24.0	24.0	16.0
Common stock	20.0	20.0	20.0	20.0
Additional paid up capital	10.0	10.0	10.0	10.0
Retained income	<u>46.0</u>	<u>50.2</u>	<u>55.2</u>	<u>64.5</u>
	<u>100.0</u>	<u>104.2</u>	<u>109.2</u>	<u>110.5</u>
Market value of equity (31 December)	167	203	199	145

Other information:

- Beta of firm = 1.
- Debtholders' required rate of return: 5%.
- Equityholders' required rate of return: 15%.
- After tax WACC: 12.5%.
- Tax rate: 45%.

Notes:

1. Depreciation included in cost of goods sold and administrative expenses is 12m, 10.5m, and 9.6m for 20X6, 20X5, and 20X4, respectively.
2. \$8m of debt was redeemed at the end of 20X6.
3. Other than the debt redeemed in 20X6, Prizm's liabilities consist mostly of long-term debt valued approximately at book value.
4. Replacement value of assets is roughly equal to book value minus 4%.

Prizm's free cash flow to equity (FCFE) for 20X6 is *closest* to:

- A) 3 million.
- B) 13 million.
- C) 15 million.

Question #42 of 60

Question ID: 691750

Asante Bizou is an equity analyst for Alpha, Inc., a boutique consulting firm in San Jose, CA. Alpha is providing consulting services to Prizm's board in evaluating the performance of Prizm's management. Bizou reviews Prizm's key financial data for the past three years.

Selected information from Prizm's financial statements is given in Exhibit 1.

Exhibit 1: Selected Prizm Financial Data

<i>Income Statement</i>	20X4	20X5	20X6
	\$m	\$m	\$m
Sales	40.2	42.3	43.9
Cost of goods sold	<u>(11.6)</u>	<u>(12.3)</u>	<u>(12.8)</u>
Gross profit	28.6	30.0	31.1
Administrative expenses	<u>(10.0)</u>	<u>(10.0)</u>	<u>(3.0)</u>
Earnings before interest and tax	18.6	20.0	28.1
Interest	<u>(6.3)</u>	<u>(6.3)</u>	<u>(4.2)</u>
Earnings before tax	12.3	13.7	23.9
Tax	<u>(5.1)</u>	<u>(5.6)</u>	<u>(11.4)</u>
Net income	7.2	8.1	12.5
Dividends	<u>(3.0)</u>	<u>(3.1)</u>	<u>(3.2)</u>
Retained income	4.2	5.0	9.3

Exhibit 1: Selected Prizm Financial Data (continued)

<i>Balance Sheet at 31 December</i>	20X3	20X4	20X5	20X6
	\$m	\$m	\$m	\$m
Working capital	24.0	25.6	27.2	32.4
Fixed assets	<u>76.0</u>	<u>78.6</u>	<u>82.0</u>	<u>78.1</u>
Total assets	<u>100.0</u>	<u>104.2</u>	<u>109.2</u>	<u>110.5</u>
Liabilities	24.0	24.0	24.0	16.0
Common stock	20.0	20.0	20.0	20.0
Additional paid up capital	10.0	10.0	10.0	10.0
Retained income	<u>46.0</u>	<u>50.2</u>	<u>55.2</u>	<u>64.5</u>
	<u>100.0</u>	<u>104.2</u>	<u>109.2</u>	<u>110.5</u>
Market value of equity (31 December)	167	203	199	145

Other information:

- Beta of firm = 1.
- Debtholders' required rate of return: 5%.
- Equityholders' required rate of return: 15%.
- After tax WACC: 12.5%.
- Tax rate: 45%.

Notes:

1. Depreciation included in cost of goods sold and administrative expenses is 12m, 10.5m, and 9.6m for 20X6, 20X5, and 20X4, respectively.

2. \$8m of debt was redeemed at the end of 20X6.
3. Other than the debt redeemed in 20X6, Prizm's liabilities consist mostly of long-term debt valued approximately at book value.
4. Replacement value of assets is roughly equal to book value minus 4%.

For this question only, assume that the chairman has drawn up budgetary forecasts for 20X7 that suggest that residual income will be \$5m for the year ahead. You believe that this will increase by 5% per year for the foreseeable future.

Using the residual income method, the value of Prizm's equity as of 31st December 20X6 is *closest* to:

- A) \$144.5 million.
- B) \$147.0 million.
- C) \$177.2 million.

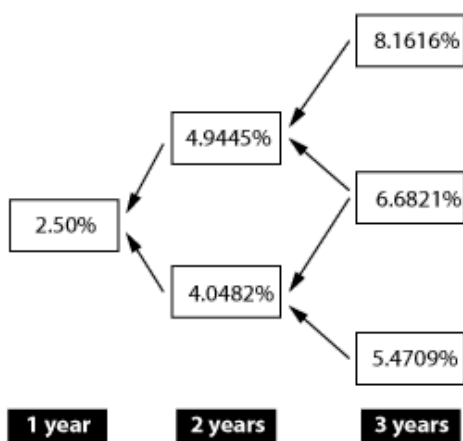
Question #43 of 60

Question ID: 693189

Use the following information to answer Questions 103 through 108.

Juanita Joplin has just begun her summer internship in the bond trading department of Bearclaw Bank NA. Joplin is assigned to Suzanne Thomas who specializes in AA-rated corporate bonds. Thomas explains to Joplin that she relies on binomial interest rate trees to value bonds with embedded options. Thomas provides Joplin with a binomial interest rate tree derived from current swap rates using an interest rate volatility assumption of 10% as shown in Exhibit 1.

Exhibit 1: Binomial Interest Rate Tree ($\sigma = 10\%$, annual pay)



Thomas then illustrates valuation of two bonds issued by Dxon Corp. Thomas states that the credit risk of the two bonds is similar to the credit risk premium embedded in the swap rate. Selected data for the two bonds is provided in Exhibit 2.

Exhibit 2: Selected Data on Two Dxon Bonds

<i>Bond</i>	<i>A</i>	<i>B</i>
Coupon	5%, annual pay	5%, annual pay
Par Value	\$100	\$100
Type	Option-Free	Extendible*
Majority	3 years	2 years

*Bond B has an investor option to extend its maturity for an additional year at the same coupon rate.

Thomas states that pathwise valuation can also be used for the bonds instead of the binomial tree approach. She highlights one of the interest rate paths (labeled Path X) as 2.50% in year 1, 4.9445% in year 2 and 6.6821% in year 3.

Joplin feels that the default risk of Dxon Corp. is higher than the default risk of the surveyed banks reflected in the rates used to generate the interest rate tree in Exhibit 1. Accordingly, a spread should be added to the interest rate tree used in Exhibit 1. She learns that such a spread is called the OAS.

During lunch, Joplin sits next to Rex Briar, another intern. Briar notes that Bond B has an OAS of 28 basis points. Another bond, issued by Geneva Inc., has the same credit quality and other features as Bond B, except it is option free. The OAS for the Geneva Inc., bond is 24 basis points.

Joplin read a report prepared by Thomas for the risk management department of the bank. She underlines the following statement in the report:

"The effective duration of a callable bond is greater than the effective duration of a comparable option-free bond. Furthermore, a bond with an embedded at- or near-the-money call option would have a lower one-sided down duration as compared to the one-sided down duration for a comparable option-free bond."

Using the information in Exhibits 1 and 2, the value of bond A is *closest* to:

- A) \$98.96.
- B) \$100.16.
- C) \$101.39.

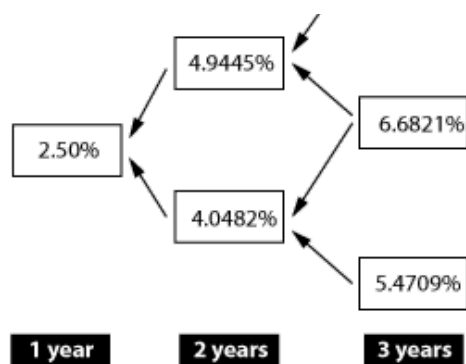
Question #44 of 60

Question ID: 693190

Juanita Joplin has just begun her summer internship in the bond trading department of Bearclaw Bank NA. Joplin is assigned to Suzanne Thomas who specializes in AA-rated corporate bonds. Thomas explains to Joplin that she relies on binomial interest rate trees to value bonds with embedded options. Thomas provides Joplin with a binomial interest rate tree derived from current swap rates using an interest rate volatility assumption of 10% as shown in Exhibit 1.

Exhibit 1: Binomial Interest Rate Tree ($\sigma = 10\%$, annual pay)

8.1616%



Thomas then illustrates valuation of two bonds issued by Dxon Corp. Thomas states that the credit risk of the two bonds is similar to the credit risk premium embedded in the swap rate. Selected data for the two bonds is provided in Exhibit 2.

Exhibit 2: Selected Data on Two Dxon Bonds

Bond	A	B
Coupon	5%, annual pay	5%, annual pay
Par Value	\$100	\$100
Type	Option-Free	Extendible*
Majority	3 years	2 years

*Bond B has an investor option to extend its maturity for an additional year at the same coupon rate.

Thomas states that pathwise valuation can also be used for the bonds instead of the binomial tree approach. She highlights one of the interest rate paths (labeled Path X) as 2.50% in year 1, 4.9445% in year 2 and 6.6821% in year 3.

Joplin feels that the default risk of Dxon Corp. is higher than the default risk of the surveyed banks reflected in the rates used to generate the interest rate tree in Exhibit 1. Accordingly, a spread should be added to the interest rate tree used in Exhibit 1. She learns that such a spread is called the OAS.

During lunch, Joplin sits next to Rex Briar, another intern. Briar notes that Bond B has an OAS of 28 basis points. Another bond, issued by Geneva Inc., has the same credit quality and other features as Bond B, except it is option free. The OAS for the Geneva Inc., bond is 24 basis points.

Joplin read a report prepared by Thomas for the risk management department of the bank. She underlines the following statement in the report:

"The effective duration of a callable bond is greater than the effective duration of a comparable option-free bond. Furthermore, a bond with an embedded at- or near-the-money call option would have a lower one-sided down duration as compared to the one-sided down duration for a comparable option-free bond."

The value of Bond A under path X is *closest* to:

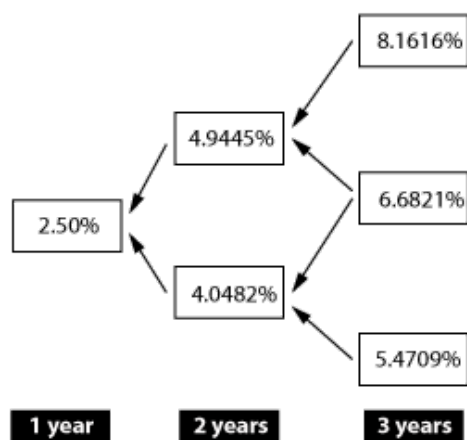
- A) \$98.02
- B) \$99.63
- C) \$101.02

Question #45 of 60

Question ID: 693192

Juanita Joplin has just begun her summer internship in the bond trading department of Bearclaw Bank NA. Joplin is assigned to Suzanne Thomas who specializes in AA-rated corporate bonds. Thomas explains to Joplin that she relies on binomial interest rate trees to value bonds with embedded options. Thomas provides Joplin with a binomial interest rate tree derived from current swap rates using an interest rate volatility assumption of 10% as shown in Exhibit 1.

Exhibit 1: Binomial Interest Rate Tree ($\sigma = 10\%$, annual pay)



Thomas then illustrates valuation of two bonds issued by Dxon Corp. Thomas states that the credit risk of the two bonds is similar to the credit risk premium embedded in the swap rate. Selected data for the two bonds is provided in Exhibit 2.

Exhibit 2: Selected Data on Two Dxon Bonds

Bond	A	B
Coupon	5%, annual pay	5%, annual pay
Par Value	\$100	\$100
Type	Option-Free	Extendible*
Majority	3 years	2 years

*Bond B has an investor option to extend its maturity for an additional year at the same coupon rate.

Thomas states that pathwise valuation can also be used for the bonds instead of the binomial tree approach. She highlights one of the interest rate paths (labeled Path X) as 2.50% in year 1, 4.9445% in year 2 and 6.6821% in year 3.

Joplin feels that the default risk of Dxon Corp. is higher than the default risk of the surveyed banks reflected in the rates used to generate the interest rate tree in Exhibit 1. Accordingly, a spread should be added to the interest rate tree used in Exhibit 1. She learns that such a spread is called the OAS.

During lunch, Joplin sits next to Rex Briar, another intern. Briar notes that Bond B has an OAS of 28 basis points. Another bond, issued by Geneva Inc., has the same credit quality and other features as Bond B, except it is option free. The OAS for the Geneva Inc., bond is 24 basis points.

"The effective duration of a callable bond is greater than the effective duration of a comparable option-free bond. Furthermore, a bond with an embedded at- or near-the-money call option would have a lower one-sided down duration as compared to the one-sided down duration for a comparable option-free bond."

Using the information in Exhibits 1 and 2, the value of bond B is *closest* to:

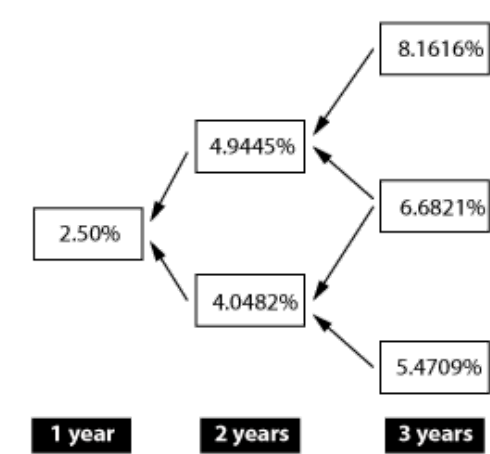
- A) \$98.96.
- B) \$101.16.
- C) \$102.91.

Question #46 of 60

Question ID: 693191

Juanita Joplin has just begun her summer internship in the bond trading department of Bearclaw Bank NA. Joplin is assigned to Suzanne Thomas who specializes in AA-rated corporate bonds. Thomas explains to Joplin that she relies on binomial interest rate trees to value bonds with embedded options. Thomas provides Joplin with a binomial interest rate tree derived from current swap rates using an interest rate volatility assumption of 10% as shown in Exhibit 1.

Exhibit 1: Binomial Interest Rate Tree ($\sigma = 10\%$, annual pay)



Thomas then illustrates valuation of two bonds issued by Dxon Corp. Thomas states that the credit risk of the two bonds is similar to the credit risk premium embedded in the swap rate. Selected data for the two bonds is provided in Exhibit 2.

Exhibit 2: Selected Data on Two Dxon Bonds

Bond	A	B
Coupon	5%, annual pay	5%, annual pay
Par Value	\$100	\$100
Type	Option-Free	Extendible*

Majority

3 years

2 years

*Bond B has an investor option to extend its maturity for an additional year at the same coupon rate.

Thomas states that pathwise valuation can also be used for the bonds instead of the binomial tree approach. She highlights one of the interest rate paths (labeled Path X) as 2.50% in year 1, 4.9445% in year 2 and 6.6821% in year 3.

Joplin feels that the default risk of Dxon Corp. is higher than the default risk of the surveyed banks reflected in the rates used to generate the interest rate tree in Exhibit 1. Accordingly, a spread should be added to the interest rate tree used in Exhibit 1. She learns that such a spread is called the OAS.

During lunch, Joplin sits next to Rex Briar, another intern. Briar notes that Bond B has an OAS of 28 basis points. Another bond, issued by Geneva Inc., has the same credit quality and other features as Bond B, except it is option free. The OAS for the Geneva Inc., bond is 24 basis points.

Joplin read a report prepared by Thomas for the risk management department of the bank. She underlines the following statement in the report:

"The effective duration of a callable bond is greater than the effective duration of a comparable option-free bond. Furthermore, a bond with an embedded at- or near-the-money call option would have a lower one-sided down duration as compared to the one-sided down duration for a comparable option-free bond."

For this question only, assume that Joplin is right about the credit risk of Dxon bonds. If the volatility estimate used in generating the interest rate tree is less than the true volatility, which of the following choices *most accurately* describes the impact on the calculated value of bond B and the estimated OAS of bond B?

Value of bond BEstimated OAS of bond B

- | | |
|-------------------|----------|
| A) Underestimated | Too low |
| B) Underestimated | Too high |
| C) Overestimated | Too high |

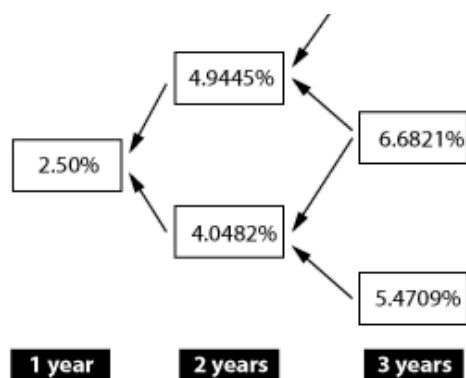
Question #47 of 60

Question ID: 693193

Juanita Joplin has just begun her summer internship in the bond trading department of Bearclaw Bank NA. Joplin is assigned to Suzanne Thomas who specializes in AA-rated corporate bonds. Thomas explains to Joplin that she relies on binomial interest rate trees to value bonds with embedded options. Thomas provides Joplin with a binomial interest rate tree derived from current swap rates using an interest rate volatility assumption of 10% as shown in Exhibit 1.

Exhibit 1: Binomial Interest Rate Tree ($\sigma = 10\%$, annual pay)

8.1616%



Thomas then illustrates valuation of two bonds issued by Dxon Corp. Thomas states that the credit risk of the two bonds is similar to the credit risk premium embedded in the swap rate. Selected data for the two bonds is provided in Exhibit 2.

Exhibit 2: Selected Data on Two Dxon Bonds

Bond	A	B
Coupon	5%, annual pay	5%, annual pay
Par Value	\$100	\$100
Type	Option-Free	Extendible*
Majority	3 years	2 years

*Bond B has an investor option to extend its maturity for an additional year at the same coupon rate.

Thomas states that pathwise valuation can also be used for the bonds instead of the binomial tree approach. She highlights one of the interest rate paths (labeled Path X) as 2.50% in year 1, 4.9445% in year 2 and 6.6821% in year 3.

Joplin feels that the default risk of Dxon Corp. is higher than the default risk of the surveyed banks reflected in the rates used to generate the interest rate tree in Exhibit 1. Accordingly, a spread should be added to the interest rate tree used in Exhibit 1. She learns that such a spread is called the OAS.

During lunch, Joplin sits next to Rex Briar, another intern. Briar notes that Bond B has an OAS of 28 basis points. Another bond, issued by Geneva Inc., has the same credit quality and other features as Bond B, except it is option free. The OAS for the Geneva Inc., bond is 24 basis points.

Joplin read a report prepared by Thomas for the risk management department of the bank. She underlines the following statement in the report:

"The effective duration of a callable bond is greater than the effective duration of a comparable option-free bond. Furthermore, a bond with an embedded at- or near-the-money call option would have a lower one-sided down duration as compared to the one-sided down duration for a comparable option-free bond."

Relative to Bond B, the Geneva Inc. bond is *most likely* to be:

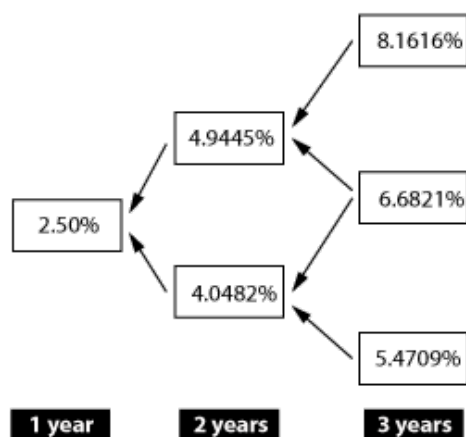
- A) underpriced.
- B) overpriced.
- C) correctly priced.

Question #48 of 60

Question ID: 693194

Juanita Joplin has just begun her summer internship in the bond trading department of Bearclaw Bank NA. Joplin is assigned to Suzanne Thomas who specializes in AA-rated corporate bonds. Thomas explains to Joplin that she relies on binomial interest rate trees to value bonds with embedded options. Thomas provides Joplin with a binomial interest rate tree derived from current swap rates using an interest rate volatility assumption of 10% as shown in Exhibit 1.

Exhibit 1: Binomial Interest Rate Tree ($\sigma = 10\%$, annual pay)



Thomas then illustrates valuation of two bonds issued by Dxon Corp. Thomas states that the credit risk of the two bonds is similar to the credit risk premium embedded in the swap rate. Selected data for the two bonds is provided in Exhibit 2.

Exhibit 2: Selected Data on Two Dxon Bonds

Bond	A	B
Coupon	5%, annual pay	5%, annual pay
Par Value	\$100	\$100
Type	Option-Free	Extendible*
Majority	3 years	2 years

*Bond B has an investor option to extend its maturity for an additional year at the same coupon rate.

Thomas states that pathwise valuation can also be used for the bonds instead of the binomial tree approach. She highlights one of the interest rate paths (labeled Path X) as 2.50% in year 1, 4.9445% in year 2 and 6.6821% in year 3.

Joplin feels that the default risk of Dxon Corp. is higher than the default risk of the surveyed banks reflected in the rates used to generate the interest rate tree in Exhibit 1. Accordingly, a spread should be added to the interest rate tree used in Exhibit 1. She learns that such a spread is called the OAS.

During lunch, Joplin sits next to Rex Briar, another intern. Briar notes that Bond B has an OAS of 28 basis points. Another bond, issued by Geneva Inc., has the same credit quality and other features as Bond B, except it is option free. The OAS for the Geneva Inc., bond is 24 basis points.

Joplin read a report prepared by Thomas for the risk management department of the bank. She underlines the following statement in the report:

"The effective duration of a callable bond is greater than the effective duration of a comparable option-free bond. Furthermore, a bond with an embedded at- or near-the-money call option would have a lower one-sided down duration as compared to the one-sided down duration for a comparable option-free bond."

Thomas's statement in the report to the risk management department is *most likely*:

- A) correct.
- B) incorrect about effective duration only.
- C) incorrect about effective duration and about one-sided duration.

Question #49 of 60

Question ID: 693195

Use the following information to answer Questions 109 through 114.

Michelle Norris, CFA, manages assets for individual investors in the United States as well as in other countries. Norris limits the scope of her practice to equity securities traded on U.S. stock exchanges. Her partner, John Witkowski, handles any requests for international securities. Recently, one of Norris's wealthiest clients suffered a substantial decline in the value of his international portfolio. Worried that his U.S. allocation might suffer the same fate, he has asked Norris to implement a hedge on his portfolio. Norris has agreed to her client's request and is currently in the process of evaluating several futures contracts. Her primary interest is in a futures contract on a broad equity index that will expire 240 days from today. The closing price as of yesterday, January 17, for the equity index was 1,050. The expected dividends from the index yield 2% (continuously compounded annual rate). The continuously compounded risk-free rate is 4%. Norris decides that this equity index futures contract is the appropriate hedge for her client's portfolio and enters into the contract.

Sixty days after entering into the futures contract, the equity index reached a level of 1,015. The futures contract that Norris purchased is now trading on the Chicago Mercantile Exchange for a price of 1,035. Interest rates have not changed. After performing some calculations, Norris calls her client to let him know of an arbitrage opportunity related to his futures position. Over the phone, Norris makes the following comments to her client:

"We have an excellent opportunity to earn a riskless profit by engaging in arbitrage using the equity index, risk-free assets, and futures contracts. My recommended strategy is as follows: We should sell the equity index short, buy the futures contract, and pay any dividends occurring over the life of the contract. By pursuing this strategy, we can generate profits for your portfolio without incurring any risk."

Sixty days ago when the Swiss franc/euro exchange rate was SF1.12 per euro, Witkowski entered into (on behalf of a client) a one-year, quarterly settlement euro-Swiss franc swap paying €1 million at inception. The fixed-for-fixed swap had the franc fixed rate at 0.96% and the euro fixed rate at 0.78%. Currently, the euro position has a value of €1.0014 per €1 notional and the exchange rate is SF 1.10 per euro. Exhibit 1 provides information about Swiss interest rates.

Exhibit 1: Swiss Interest Rates

EXHIBIT 1. SWISS Interest Rates

<i>Term</i>	<i>Rate</i>	<i>PV of \$1</i>
30	0.50%	0.9996
60	0.54%	0.9991
90	0.48%	0.9988
120	0.65%	0.9978
180	0.77%	0.9962
210	0.67%	0.9961
300	0.82%	0.9932
360	1%	0.9901

The price of the futures contract on the equity index as of the inception date, January 18, is *closest* to:

- A) 1,064.
- B) 1,071.
- C) 1,078.

Question #50 of 60

Question ID: 693196

Michelle Norris, CFA, manages assets for individual investors in the United States as well as in other countries. Norris limits the scope of her practice to equity securities traded on U.S. stock exchanges. Her partner, John Witkowski, handles any requests for international securities. Recently, one of Norris's wealthiest clients suffered a substantial decline in the value of his international portfolio. Worried that his U.S. allocation might suffer the same fate, he has asked Norris to implement a hedge on his portfolio. Norris has agreed to her client's request and is currently in the process of evaluating several futures contracts. Her primary interest is in a futures contract on a broad equity index that will expire 240 days from today. The closing price as of yesterday, January 17, for the equity index was 1,050. The expected dividends from the index yield 2% (continuously compounded annual rate). The continuously compounded risk-free rate is 4%. Norris decides that this equity index futures contract is the appropriate hedge for her client's portfolio and enters into the contract.

Sixty days after entering into the futures contract, the equity index reached a level of 1,015. The futures contract that Norris purchased is now trading on the Chicago Mercantile Exchange for a price of 1,035. Interest rates have not changed. After performing some calculations, Norris calls her client to let him know of an arbitrage opportunity related to his futures position. Over the phone, Norris makes the following comments to her client:

"We have an excellent opportunity to earn a riskless profit by engaging in arbitrage using the equity index, risk-free assets, and futures contracts. My recommended strategy is as follows: We should sell the equity index short, buy the futures contract, and pay any dividends occurring over the life of the contract. By pursuing this strategy, we can generate profits for your portfolio without incurring any risk."

one-year, quarterly settlement euro-Swiss franc swap paying €1 million at inception. The fixed-for-fixed swap had the franc fixed rate at 0.96% and the euro fixed rate at 0.78%. Currently, the euro position has a value of €1.0014 per €1 notional and the exchange rate is SF 1.10 per euro. Exhibit 1 provides information about Swiss interest rates.

Exhibit 1: Swiss Interest Rates

<i>Term</i>	<i>Rate</i>	<i>PV of \$1</i>
30	0.50%	0.9996
60	0.54%	0.9991
90	0.48%	0.9988
120	0.65%	0.9978
180	0.77%	0.9962
210	0.67%	0.9961
300	0.82%	0.9932
360	1%	0.9901

Which of the following *best* describes the movement of the futures price on the 240-day equity index futures contract as the contract moves toward the expiration date?

- A) The futures price will move toward zero as expiration nears.
- B) The futures price will move toward the (at inception) expected spot price as expiration nears.
- C) The futures price will move toward the spot price as expiration nears.

Question #51 of 60

Question ID: 693197

Michelle Norris, CFA, manages assets for individual investors in the United States as well as in other countries. Norris limits the scope of her practice to equity securities traded on U.S. stock exchanges. Her partner, John Witkowski, handles any requests for international securities. Recently, one of Norris's wealthiest clients suffered a substantial decline in the value of his international portfolio. Worried that his U.S. allocation might suffer the same fate, he has asked Norris to implement a hedge on his portfolio. Norris has agreed to her client's request and is currently in the process of evaluating several futures contracts. Her primary interest is in a futures contract on a broad equity index that will expire 240 days from today. The closing price as of yesterday, January 17, for the equity index was 1,050. The expected dividends from the index yield 2% (continuously compounded annual rate). The continuously compounded risk-free rate is 4%. Norris decides that this equity index futures contract is the appropriate hedge for her client's portfolio and enters into the contract.

Sixty days after entering into the futures contract, the equity index reached a level of 1,015. The futures contract that Norris purchased is now trading on the Chicago Mercantile Exchange for a price of 1,035. Interest rates have not changed. After performing some calculations, Norris calls her client to let him know of an arbitrage opportunity related to his futures position. Over the phone, Norris makes the following comments to her client:

"We have an excellent opportunity to earn a riskless profit by engaging in arbitrage using the equity index, risk-free assets, and futures contracts. My recommended strategy is as follows: We should sell the equity index short, buy the futures contract, and pay any dividends occurring over the life of the contract. By pursuing this strategy, we can generate profits for your portfolio without incurring any risk."

Sixty days ago when the Swiss franc/euro exchange rate was SF1.12 per euro, Witkowski entered into (on behalf of a client) a one-year, quarterly settlement euro-Swiss franc swap paying €1 million at inception. The fixed-for-fixed swap had the franc fixed rate at 0.96% and the euro fixed rate at 0.78%. Currently, the euro position has a value of €1.0014 per €1 notional and the exchange rate is SF 1.10 per euro. Exhibit 1 provides information about Swiss interest rates.

Exhibit 1: Swiss Interest Rates

<i>Term</i>	<i>Rate</i>	<i>PV of \$1</i>
30	0.50%	0.9996
60	0.54%	0.9991
90	0.48%	0.9988
120	0.65%	0.9978
180	0.77%	0.9962
210	0.67%	0.9961
300	0.82%	0.9932
360	1%	0.9901

Sixty days after the inception of the futures contract on the equity index, Norris has suggested an arbitrage strategy. Regarding the appropriateness of the strategy, the strategy is *best* described as:

- A) appropriate since the futures contract is underpriced.
- B) inappropriate since the futures contract is overpriced.
- C) inappropriate since the futures contract is properly priced in the market.

Question #52 of 60

Question ID: 693198

Michelle Norris, CFA, manages assets for individual investors in the United States as well as in other countries. Norris limits the scope of her practice to equity securities traded on U.S. stock exchanges. Her partner, John Witkowski, handles any requests for international securities. Recently, one of Norris's wealthiest clients suffered a substantial decline in the value of his international portfolio. Worried that his U.S. allocation might suffer the same fate, he has asked Norris to implement a hedge on his portfolio. Norris has agreed to her client's request and is currently in the process of evaluating several futures contracts. Her primary interest is in a futures contract on a broad equity index that will expire 240 days from today. The closing price as of yesterday, January 17, for the equity index was 1,050. The expected dividends from the index yield 2% (continuously compounded annual rate). The continuously compounded risk-free rate is 4%. Norris decides that this equity index futures

contract is the appropriate hedge for her client's portfolio and enters into the contract.

Sixty days after entering into the futures contract, the equity index reached a level of 1,015. The futures contract that Norris purchased is now trading on the Chicago Mercantile Exchange for a price of 1,035. Interest rates have not changed. After performing some calculations, Norris calls her client to let him know of an arbitrage opportunity related to his futures position. Over the phone, Norris makes the following comments to her client:

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180	0.77%	0.9962
210	0.67%	0.9961
300	0.82%	0.9932
360	1%	0.9901

.....

If the expected growth rate in dividends for stocks increases by 75 basis points, which of the following would benefit the most?
An investor who:

- A)** is short futures contracts on the equity index.
- B)** is long futures contracts on the equity index.
- C)** has a long position in put options on the equity index.

Question #53 of 60

Question ID: 693199

Michelle Norris, CFA, manages assets for individual investors in the United States as well as in other countries. Norris limits the scope of her practice to equity securities traded on U.S. stock exchanges. Her partner, John Witkowski, handles any requests for international securities. Recently, one of Norris's wealthiest clients suffered a substantial decline in the value of his

international portfolio. Worried that his U.S. allocation might suffer the same fate, he has asked Norris to implement a hedge on his portfolio. Norris has agreed to her client's request and is currently in the process of evaluating several futures contracts. Her primary interest is in a futures contract on a broad equity index that will expire 240 days from today. The closing price as of yesterday, January 17, for the equity index was 1,050. The expected dividends from the index yield 2% (continuously compounded annual rate). The continuously compounded risk-free rate is 4%. Norris decides that this equity index futures contract is the appropriate hedge for her client's portfolio and enters into the contract.

Sixty days after entering into the futures contract, the equity index reached a level of 1,015. The futures contract that Norris purchased is now trading on the Chicago Mercantile Exchange for a price of 1,035. Interest rates have not changed. After performing some calculations, Norris calls her client to let him know of an arbitrage opportunity related to his futures position. Over the phone, Norris makes the following comments to her client:

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90	0.48%	0.9988
120	0.65%	0.9978
180	0.77%	0.9962
210	0.67%	0.9961
300	0.82%	0.9932
360	1%	0.9901

Sixty days after entering into the equity index futures contract, the value to the short party under the futures contract as compared to the value under an otherwise identical forward contract would *most likely* be:

- A) lower.
- B) the same.
- C) higher.

Question #54 of 60

Question ID: 693200

Michelle Norris, CFA, manages assets for individual investors in the United States as well as in other countries. Norris limits the scope of her practice to equity securities traded on U.S. stock exchanges. Her partner, John Witkowski, handles any requests for international securities. Recently, one of Norris's wealthiest clients suffered a substantial decline in the value of his international portfolio. Worried that his U.S. allocation might suffer the same fate, he has asked Norris to implement a hedge on his portfolio. Norris has agreed to her client's request and is currently in the process of evaluating several futures contracts. Her primary interest is in a futures contract on a broad equity index that will expire 240 days from today. The closing price as of yesterday, January 17, for the equity index was 1,050. The expected dividends from the index yield 2% (continuously compounded annual rate). The continuously compounded risk-free rate is 4%. Norris decides that this equity index futures contract is the appropriate hedge for her client's portfolio and enters into the contract.

Sixty days after entering into the futures contract, the equity index reached a level of 1,015. The futures contract that Norris purchased is now trading on the Chicago Mercantile Exchange for a price of 1,035. Interest rates have not changed. After performing some calculations, Norris calls her client to let him know of an arbitrage opportunity related to his futures position. Over the phone, Norris makes the following comments to her client:

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Exhibit 1: Swiss Interest Rates

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90	0.48%	0.9988
120	0.65%	0.9978
180	0.77%	0.9962
210	0.67%	0.9961
300	0.82%	0.9932
360	1%	0.9901

Sixty days after inception, the value of the currency swap to Witkowski's client is *closest* to:

- A) -€19,633
- B) -€141,584

C) -€1,021,033

Question #55 of 60

Question ID: 693201

Use the following information to answer Questions 115 through 120.

Tamara Ogle, CFA, and Isaac Segovia, CAIA, are portfolio managers for Lucas Investment Management (Lucas). Ogle and Segovia both manage large institutional investment portfolios and are working together to research portfolio optimization strategies. Ogle mentions the Premier fund. Exhibit 1 shows the Premier fund's exposures and expected return, as well as benchmark specifications.

Exhibit 1: Premier Fund Characteristics

<i>Security</i>	<i>Portfolio Weight</i>	<i>Benchmark Weight</i>	<i>Return</i>
<i>(i)</i>	<i>(w_{Pi})</i>	<i>(w_{Bi})</i>	<i>E(R_i)</i>
X	35%	40%	11.20%
Y	20%	25%	4.25%
Z	45%	35%	14.00%
Total	100%	100%	

Ogle states that the information ratio for a manager is a good indicator of relative performance. Ogle also makes the following statements:

Statement 1: "Unlike the Sharpe ratio, the information ratio can be affected by the addition of cash or leverage."

Statement 2: "The information ratio of an unconstrained portfolio is unaffected by aggressiveness of the active weights."

Statement 3: "Among active portfolios, the portfolio with the highest information ratio need not have the highest Sharpe ratio."

Statement 4: "The optimal active risk for an unconstrained portfolio is less than the optimal active risk for a constrained portfolio."

Ogle then considers the Dena and Orient funds. Exhibit 2 shows selected data for the two funds.

Exhibit 2: Selected Information for Dena and Orient Funds

	<i>Dena</i>	<i>Orient</i>
Information coefficient	0.20	0.25
Transfer coefficient	0.99	0.80
Independent bets/year	12	X

Segovia also considers three funds that specialize in market timing. Information about the funds is given in Exhibit 3.

Exhibit 3: Selected Fund Data

	A	B	C
Frequency of bets per year	12	4	2
Number of independent stocks followed	2	3	2
Probability of correct call	0.52	0.58	0.59

Based on the information in Exhibit 1, the ex-ante active return for the Premier fund is *closest* to:

- A) 0.63%.
- B) 1.05%.
- C) 2.92%.

Question #56 of 60

Question ID: 693202

Tamara Ogle, CFA, and Isaac Segovia, CAIA, are portfolio managers for Lucas Investment Management (Lucas). Ogle and Segovia both manage large institutional investment portfolios and are working together to research portfolio optimization strategies. Ogle mentions the Premier fund. Exhibit 1 shows the Premier fund's exposures and expected return, as well as benchmark specifications.

Exhibit 1: Premier Fund Characteristics

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X	35%	40%	11.20%
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Z	45%	35%	14.00%
Total	100%	100%	

Ogle states that the information ratio for a manager is a good indicator of relative performance. Ogle also makes the following statements:

- Statement 1: "Unlike the Sharpe ratio, the information ratio can be affected by the addition of cash or leverage."
- Statement 2: "The information ratio of an unconstrained portfolio is unaffected by aggressiveness of the active weights."
- Statement 3: "Among active portfolios, the portfolio with the highest information ratio need not have the highest Sharpe ratio."
- Statement 4: "The optimal active risk for an unconstrained portfolio is less than the optimal active risk for a constrained portfolio."

Ogle then considers the Dena and Orient funds. Exhibit 2 shows selected data for the two funds.

Exhibit 2: Selected Information for Dena and Orient Funds

	<i>Dena</i>	<i>Orient</i>
Information coefficient	0.20	0.25
Transfer coefficient	0.99	0.80
Independent bets/year	12	X

Segovia also considers three funds that specialize in market timing. Information about the funds is given in Exhibit 3.

Exhibit 3: Selected Fund Data

	<i>A</i>	<i>B</i>	<i>C</i>
Frequency of bets per year	12	4	2
Number of independent stocks followed	2	3	2
Probability of correct call	0.52	0.58	0.59

Regarding Ogle's Statements 1 and 2:

- A) both statements are incorrect.
- B) one statement is correct and one is incorrect.
- C) both statements are correct.

Question #57 of 60

Question ID: 693203

Tamara Ogle, CFA, and Isaac Segovia, CAIA, are portfolio managers for Lucas Investment Management (Lucas). Ogle and Segovia both manage large institutional investment portfolios and are working together to research portfolio optimization strategies. Ogle mentions the Premier fund. Exhibit 1 shows the Premier fund's exposures and expected return, as well as benchmark specifications.

Exhibit 1: Premier Fund Characteristics

<i>Security</i> (<i>i</i>)	<i>Portfolio Weight</i> (w_{Pi})	<i>Benchmark Weight</i> (w_{Bi})	<i>Return</i> $E(R_i)$
X	35%	40%	11.20%
Y	20%	25%	4.25%
Z	45%	35%	14.00%
Total	100%	100%	

Ogle states that the information ratio for a manager is a good indicator of relative performance. Ogle also makes the following statements:

Statement 1: "Unlike the Sharpe ratio, the information ratio can be affected by the addition of cash or leverage."

Statement 2: "The information ratio of an unconstrained portfolio is unaffected by aggressiveness of the active weights."

Statement 3: "Among active portfolios, the portfolio with the highest information ratio need not have the highest Sharpe ratio."

Statement 4: "The optimal active risk for an unconstrained portfolio is less than the optimal active risk for a constrained portfolio."

Ogle then considers the Dena and Orient funds. Exhibit 2 shows selected data for the two funds.

Exhibit 2: Selected Information for Dena and Orient Funds

	<i>Dena</i>	<i>Orient</i>
Information coefficient	0.20	0.25
Transfer coefficient	0.99	0.80
Independent bets/year	12	X

Segovia also considers three funds that specialize in market timing. Information about the funds is given in Exhibit 3.

Exhibit 3: Selected Fund Data

	<i>A</i>	<i>B</i>	<i>C</i>
Frequency of bets per year	12	4	2
Number of independent stocks followed	2	3	2
Probability of correct call	0.52	0.58	0.59

Assuming that Dena Fund and Orient Fund both have the same information ratio, the value of "X" in Exhibit 2 must be *closest* to:

- A) 10.
- B) 12.
- C) 16.

Question #58 of 60

Question ID: 693204

Tamara Ogle, CFA, and Isaac Segovia, CAIA, are portfolio managers for Lucas Investment Management (Lucas). Ogle and Segovia both manage large institutional investment portfolios and are working together to research portfolio optimization strategies. Ogle mentions the Premier fund. Exhibit 1 shows the Premier fund's exposures and expected return, as well as

benchmark specifications.

Exhibit 1: Premier Fund Characteristics

Security (i)	Portfolio Weight (w_{Pi})	Benchmark Weight (w_{Bi})	Return $E(R_i)$
X	35%	40%	11.20%
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Z	45%	35%	14.00%
Total	100%	100%	

Ogle states that the information ratio for a manager is a good indicator of relative performance. Ogle also makes the following statements:

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Ogle then considers the Dena and Orient funds. Exhibit 2 shows selected data for the two funds.

Exhibit 2: Selected Information for Dena and Orient Funds

	<i>Dena</i>	<i>Orient</i>
Information coefficient	0.20	0.25
Transfer coefficient	0.99	0.80
Independent bets/year	12	X

Segovia also considers three funds that specialize in market timing. Information about the funds is given in Exhibit 3.

Exhibit 3: Selected Fund Data

	<i>A</i>	<i>B</i>	<i>C</i>
Frequency of bets per year	12	4	2
Number of independent stocks followed	2	3	2
Probability of correct call	0.52	0.58	0.59

Based on the information in Exhibit 3, an investor that wishes to construct a portfolio with an active risk of 4% would *most appropriately* choose to combine the benchmark with:

- A) fund A.
 B) fund B.
 C) fund C.

Question #59 of 60

Question ID: 693205

Tamara Ogle, CFA, and Isaac Segovia, CAIA, are portfolio managers for Lucas Investment Management (Lucas). Ogle and Segovia both manage large institutional investment portfolios and are working together to research portfolio optimization strategies. Ogle mentions the Premier fund. Exhibit 1 shows the Premier fund's exposures and expected return, as well as benchmark specifications.

Exhibit 1: Premier Fund Characteristics

Security (i)	Portfolio Weight (w_{Pi})	Benchmark Weight (w_{Bi})	Return $E(R_i)$
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Total	100%	100%	

Ogle states that the information ratio for a manager is a good indicator of relative performance. Ogle also makes the following statements:

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Ogle then considers the Dena and Orient funds. Exhibit 2 shows selected data for the two funds.

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	Dena	Orient
Information coefficient	0.20	0.25
Transfer coefficient	0.99	0.80
Independent bets/year	12	X

Segovia also considers three funds that specialize in market timing. Information about the funds is given in Exhibit 3.

Exhibit 3: Selected Fund Data

Exhibit 3: Selected Fund Data

	A	B	C
Frequency of bets per year	12	4	2
Number of independent stocks followed	2	3	2
Probability of correct call	0.52	0.58	0.59

Regarding Ogle's Statements 3 and 4:

- A) both statements are incorrect.
- B) one of the statements is correct and the other is incorrect.
- C) both statements are correct.

Question #60 of 60

Question ID: 693206

Tamara Ogle, CFA, and Isaac Segovia, CAIA, are portfolio managers for Lucas Investment Management (Lucas). Ogle and Segovia both manage large institutional investment portfolios and are working together to research portfolio optimization strategies. Ogle mentions the Premier fund. Exhibit 1 shows the Premier fund's exposures and expected return, as well as benchmark specifications.

Exhibit 1: Premier Fund Characteristics

Security (i)	Portfolio Weight (w_{Pi})	Benchmark Weight (w_{Bi})	Return $E(R_i)$
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Total	100%	100%	

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Ogle then considers the Dena and Orient funds. Exhibit 2 shows selected data for the two funds.

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Segovia also considers three funds that specialize in market timing. Information about the funds is given in Exhibit 3.

Exhibit 3: Selected Fund Data

	<i>A</i>	<i>B</i>	<i>C</i>
Frequency of bets per year	12	4	2
Number of independent stocks followed	2	3	2
Probability of correct call	0.52	0.58	0.59

As the uncertainty of the information coefficient increases, we are *most likely* to observe an increase in the:

- A)** expected active return.
- B)** ex-ante information ratio.
- C)** active risks.